

**Was Professor Ward Really Serious?
IP And Bankruptcy – When Worlds Collide**

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Intellectual property, whether in the form of a patent, copyright, trademark or otherwise,¹ can play a critical role in a bankruptcy case. Frequently, a debtor’s intellectual property portfolio will be a valuable – if not the most valuable – asset of the bankruptcy estate. This is true whether the debtor owns the intellectual property, licenses the intellectual property to third parties, is a licensee of intellectual property from third parties, or some combination of each.

This outline addresses important – and sometimes counterintuitive – issues and results that arise in connection with a bankruptcy case. *First*, we consider the impact of a bankruptcy case on debtors who license intellectual property from a non-debtor third party. *Next*, we address issues involving debtors who are licensors of intellectual property to non-debtor third parties. *Third*, we discuss legal and practical issues arising in connection with the purchase and sale of assets from bankruptcy estates. *Finally*, we survey issues relating to the avoidance and/or enforceability of security interests in a debtor’s intellectual property following a bankruptcy petition.

I. Debtors Who Are Licensees Of Intellectual Property – Does Catapult Sound A Death Knell For Debtor-Licensees?

A. *The Issue – Assumption of the License.*

1. Generally

a) When a debtor files a petition under chapter 11, the debtor remains “in possession” of its assets and retains the ability to operate its business, subject to the various limitations of the Bankruptcy Code. 11 U.S.C. § 1107. The debtor is known as the debtor in possession (or “DIP”) and has most of the rights, duties and powers of a bankruptcy trustee. *Id.* Included in these is the power to “assume” or “reject” a debtor’s “executory contracts” pursuant to the requirements of Section 365 of the Bankruptcy Code. 11 U.S.C. § 365.

2. Licenses as “Executory Contracts”

a) An executory contract is “a contract . . . on which performance is due to some extent on both sides” and in which “the obligations of both parties are so far unperformed that the failure of either party to complete performance would constitute a material breach and thus excuse the performance of the other.” *Everex Systems, Inc. v. Cadtrak Corp. (In re CFLC, Inc.)*, 89 F. 3d 673, 677 (9th Cir. 1996) (citations omitted).

¹ A short primer on different forms of intellectual property is attached to this outline as Exhibit I. This presentation focuses only on the big three – patents, copyrights and trademarks. Protection of the integrity and value of other forms of intellectual property in a bankruptcy, such as trade secrets and other confidential information, is also a key concern for debtors and non-debtors, but is beyond the scope of this presentation. The reader is directed to 11 U.S.C. § 107(b), which addresses certain of these matters.

b) The Ninth Circuit has held that license agreements in which a debtor is a licensee or licensor of intellectual property are executory contracts. *Encino Business Management, Inc. v. Prize Frize, Inc. (In re Prize Frize, Inc.)*, 32 F. 3d 426, 428 (9th Cir. 1994); *In re Select-A-Seat Corp.*, 625 F. 2d 290, 292 (9th Cir. 1994).

(i) “Courts generally have found intellectual property licenses to be ‘executory’ within the meaning of section 365(c) because each party to the license had the material duty of ‘refraining from suing the other for infringement of any of the [intellectual property] covered by the license.’” *In re Golden Books Family Entertainment Inc.*, 269 B.R. 300, 308 (Bankr. D. Del. 2001) [*Golden Books I*]; *In re Access Beyond Tech., Inc.*, 237 B.R. 32, 43 (Bankr. D. Del. 1999); *In Patient Education Media, Inc.*, 210 B.R. 237, 241 (Bankr. S.D.N.Y. 1997).

(ii) It should be noted that bankruptcy courts will deal with a contract in accordance with its substance rather than its title. Thus in certain cases an agreement that is nominally a license may be treated as a non-executory contract if the nature of the agreement is other than a true license. *See, e.g., Microsoft Corp. v. DAK Industries, Inc. (In re DAK Industries, Inc.)*, 66 F. 3d 1091, 1095 (9th Cir. 1995) (finding no executory contract where “agreement [was] best characterized as a lump sum sale of software units to DAK, rather than a grant of permission to use an intellectual property”); *Stevens v. CSA, Inc.*, 271 B.R. 410, 413-14 (D. Mass. 2001) (settlement agreement that provided limited nonexclusive license to debtor in order for debtor to sell existing inventory was not an “executory contract”); *Official Unsecured Creditors’ Comm. v. Zenith Prod. Ltd. (In re AEG Acquisition Corp.)*, 127 B.R. 34, 45 (Bankr. C.D. Cal. 1991) (“Where the seller has already delivered the subject of the transfer, and the principal remaining obligation between the parties is the purchaser’s obligation to pay, a[n] option] contract with respect to motion picture distribution agreements] is not executory.”).

3. Sections 365(c), 365(f) and “Applicable Law”

a) Bankruptcy Code language.

(i) Section 365(c)(1) of the Bankruptcy Code limits a DIP’s ability to “assume or assign” certain executory contracts without the consent of the non-debtor party, specifically where “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 or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties.” 11 U.S.C. § 365(c)(1). This is colloquially known as the exemption for personal services contacts.

(ii) As discussed in Section I.B.1., below, Section 365(c)(1) appears to conflict with Section 365(f)(1) of the Bankruptcy Code, which permits a DIP to assign an executory contract “notwithstanding a provision in an executory

contract . . . or in applicable law that prohibits, restricts, or conditions the assignment of such contract.” 11 U.S.C. § 365(f)(1).

(iii) However, a DIP must assume an executory contract before assigning it. 11 U.S.C. § 365(f)(2). Given that, how can it be that a DIP may assign a contract “notwithstanding a provision in applicable law that prohibits assignment” under Section 365(f), if that “applicable law” as applied through Section 365(c)(1) prevents the DIP from assuming the contract in the first place?

b) Which law is the “applicable law” at issue in Sections 365(c) and 365(f)?

(i) Generally, California law and many other state laws permit the free assignment of contracts unless the contracts themselves expressly prohibit assignment. Cal. Civ. Code § 1458 (“A right arising out of an obligation is the property of the person to whom it is due, and may be transferred as such.”).

(ii) Federal law, however, preempts state law. Thus courts have found that the assignability of contracts dealing with patent licenses is determined by federal law. *See, e.g., Perlman v. Catapult Entertainment, Inc. (In re Catapult Entertainment, Inc.)*, 165 F. 3d 747, 750 (9th Cir. 1999) (“our precedents make it clear that federal patent law constitutes ‘applicable law’ within the meaning of § 365(c)”; *CFLC*, 89 F. 3d at 679 (concluding that permitting states to have the power to allow unfettered assignability of patent licenses would discourage rather than encourage invention because it would reduce the value of nonexclusive licenses, shift control away from licensors, and possibly eliminate paid up licenses); *In re Alltech Plastics, Inc.*, 71 B.R. 686, 689 (Bankr. W.D. Tenn. 1987) (“questions regarding the assignability of patent licenses are controlled by federal law”).

(iii) Federal law also has been held to be the “applicable law” when determining assignability of –

aa. Copyright licenses. *RCC Technology Corporation v. Sunterra Corporation*, 287 B.R. 864, 865 (D. Md. 2003); *rev’d on other grounds, sub. nom RCI Technology Corp. v. Sunterra Corp.*, 361 F.2d 257 (4th Cir. 2004); *In re Patient Education Media Inc.*, 210 B.R. 237, 242 (Bankr. S.D.N.Y. 1997) (“The federal policy designed to protect the limited monopoly of copyright owners and restrict unauthorized use constitutes applicable nonbankruptcy law [for Section 365 purposes].”); and

bb. Trademarks. *In re N.C.P. Marketing Group, Inc.*, 2005 WL 3253268, at 6 (D. Nev. 2005); *In re Travelot Co.*, 286 B.R. 447, 454 (Bankr. S.D. Ga. 2002).

B. The Ninth Circuit “Hypothetical Test” – A DIP May Not Assume A Nonexclusive Patent License

1. **Catapult.** The Ninth Circuit has held that Section 365(c)(1) prohibits the DIP from assuming a nonexclusive patent license because under federal patent law – the “applicable law” at issue – nonexclusive licenses are not freely assignable. Perlman v. Catapult Entertainment, Inc. (In re Catapult Entertainment, Inc.), 165 F. 3d 747, 750-55 (9th Cir. 1999). See also *CFLC*, 89 F. 3d at 679-80 (“Federal law holds a nonexclusive patent license to be personal and nonassignable and therefore would excuse [patent holder] from accepting performance from, or rendering it to, anyone other than [the debtor licensee]. It is well settled that a non-exclusive license of a patent has only a personal and not a property interest in the patent and that this personal right cannot be assigned unless the patent owner authorizes the assignment or the license itself permits assignment.”).

a) In reaching this result, the Ninth Circuit adopted the so-called “hypothetical test” in the interpretation of Section 365(c)(1). Under this test, a DIP may not assume an executory contract without consent if applicable law would prohibit assignment of the contract to a “hypothetical” third party, even where the DIP seeks only to assume the contract (and not to assign it to a third party), and where the DIP is the same entity as the debtor that entered into the contract. *Catapult*, 165 F. 3d at 750.

b) The Court recognized that “a literal reading of subsection (c)(1) appears to render subsection (f)(1) superfluous.” *Id.* at 751. However, the Court then drew a very fine distinction – “Subsection (f)(1) states the broad rule – a law that, as a general matter, ‘prohibits, restricts, or conditions the assignment’ of executory contracts is trumped by the provisions of subsection (f)(1). Subsection (c)(1), however, states a carefully crafted exception to the broad rule – where applicable law does not merely recite a general ban on assignment, but instead more specifically ‘excuses a party . . . from accepting performance from or rendering performance to an entity’ different from the one with which the party originally contracted, the applicable law prevails over subsection (f)(1). In other words, in determining whether an ‘applicable law’ stands or falls under § 365(f)(1), a court must ask *why* the ‘applicable law’ prohibits assignment. Only if the law prohibits assignment on the rationale that the identity of the contracting party is material to the agreement will subsection (c)(1) rescue it.” *Id.* at 752 (citations omitted).

(i) The Court further held that federal patent law was just such a law that is premised upon the identity of the contracting party: “We note that, in the instant case, the federal law principle against the assignability of nonexclusive patent licenses is rooted in the personal nature of a nonexclusive license – the identity of a licensee may matter a great deal to a licensor.” *Id.* at 752 n.4; see *CFLC*, 89 F. 3d at 679 (explaining rationale behind federal law rule against assignability).

c) The Ninth Circuit expressly disregarded legislative history from a House Report related to a technical amendment proposed in 1980 that was later enacted in 1984:

This amendment makes it clear that the prohibition against a trustee's power to assume an executory contract does not apply where it is *the debtor* that is in possession and the performance to be given or received under a personal service contract will be the same as if no petition had been filed because of the personal service nature of the contract.

H.R. Rep. 1195, 96th Cong., 2d Sess. § 27(b)(198).

C. The “Actual Test” – The First Circuit Reaches A Different Conclusion

1. **Institut Pasteur**. The First Circuit has rejected the “hypothetical test” in favor of an “actual performance test,” finding that (at least in some circumstances), the DIP may at least assume a contract even if it would be unable to assign it. *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F. 3d 489, 493 (1st Cir. 1997) (holding that a DIP/reorganized debtor could assume a nonexclusive patent license); *Summit Inv. & Dev. Corp. v. Leroux (In re Leroux)*, 69 F. 3d 608, 613 (1st Cir. 1995) (rejecting “hypothetical test” in favor of “actual test” based on the interpretation of legislative intent found in “the 1984 amendment to Section 365(c)(1) and its legislative history”).

a) The “actual performance test” is a pragmatic approach that involves a case-by-case inquiry into whether the non-debtor party actually is being subjected to accept performance from someone other than the debtor party with whom it originally contracted. *Institut Pasteur*, 104 F. 3d at 493. If not – as in cases where a DIP simply seeks to assume a contract executed by the Debtor – then Section 365(c)(1) is held not to preclude assumption.

D. Other Courts – Mixed Results

1. At least four circuits, the Third, Fourth, Ninth, and Eleventh, as well as several bankruptcy courts, have adopted or applied the “hypothetical test.” See *In re Sunterra Corp.*, 361 F. 3d 257, 265-70 (4th Cir. 2004); *Catapult; In re West Elecs., Inc.*, 852 F. 2d 79, 83 (3d Cir. 1988); *In re James Cable Partners*, 27 F. 3d 534, 537 (11th Cir. 1994); *In re Catron*, 158 B.R. 629, 633-38 (E.D. Va. 1993) (same), *aff'd without op.*, 25 F. 3d 1038 (4th Cir. 1994). In contrast, the First Circuit, along with at least a perceived majority of the bankruptcy courts, have applied the “actual test.” See *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F. 3d 489, 493 (1st Cir. 1997); see also *In re Catapult*, 165 F. 3d at 749 n. 2 (collecting bankruptcy court decisions adopting actual test); *RCC Technology*, 287 B.R. at 865-66 (adopting the “actual performance test” and authorizing the DIP to assume a software license agreement notwithstanding federal copyright law that prohibited assignment of the agreement).

E. Life After Death? Another View of “Plain Meaning”

1. **Footstar**. In *In re Footstar, Inc.*, 323 B.R. 566 (Bankr. S.D.N.Y. 2005), the bankruptcy court revisited the language of Section 365(c)(1) and concluded that, under its “plain meaning,” a debtor-in-possession can assume an agreement even where assignment is prohibited.

a) In reaching that conclusion, Judge Hardin began with the proposition that the term “trustee” as used in Section 365(c)(1) cannot automatically be defined as synonymous with “debtor-in-possession” and that the two terms have different meanings, even within sections 365(c)(1), (e)(1) and (2) and (f). *Id.* at 570-71.

b) The court concluded that the decisions in *Catapult*, *West Electronics*, and *Sunterra* were premised on the “basic misconception” that “trustee” as used in Section 365(c)(1) means ‘debtor in possession.’” *Id.* at 571.

c) The court in *Footstar* then turned to section 1107(a), which defines the rights, powers and duties of a debtor-in-possession. That statute grants a debtor-in-possession the “right” to assume contracts. The court viewed the central issue to be the effect of the prefatory language of section 1107(a), which says the DIP’s power is “[s]ubject to any limitations on a trustee . . .” Although the court found that section 1107(a) prefatory clause applies to Section 365(c)(1), the court characterized the question presented as whether “the limitation in Section 365(c)(1) as applied to the debtor-in-possession prohibits assumption without assignment.” *Id.* at 573 (emphasis in original).

d) The court ultimately concluded that the term “debtor in possession” could not logically be substituted for “trustee” under Section 365(c)(1).

(i) The court viewed Section 365(c)(1) as “quite logical and sensible” when applied to a trustee, which “is an ‘entity other than the debtor or debtor-in-possession.’” *Id.* at 572.

(ii) In contrast, the court in *Footstar* held that “it makes no sense to read ‘trustee’ to mean ‘debtor in possession’ either in the context of the statutory provision or under the plain meaning canon.” *Id.*

(iii) To make its point, the court noted that where the debtor-in-possession only seeks to assume, the statute as substituting the term debtor in possession would render the provision a “virtual oxymoron.”

[T]he *debtor in possession* may not assume . . . any contract
[. . . applicable law excuses [the counterparty] . . . from
accepting performance from a rendering performance to an
entity other than the debtor in possession . . .

Id.

e) The court in *Footstar* also relied upon the same legislative history from 1980 that the Ninth Circuit rejected in *Catapult*.

(i) Unlike in *Catapult*, the court in *Footstar* quoted the language in the Code as enacted in 1978 versus that proposed in 1980. Under the 1978 version, Section 365(c)(1)(A) spoke of “rendering performance to the trustee or an assignee of such contract or lease.” The proposed language change in 1980 that accompanied the House Report cited in *Catapult*, replaced “the trustee” with “an

entity other than the debtor or debtor in possession.” The bankruptcy court viewed the fact that Congress adopted that very language in 1984 as a good reason not to ignore the 1980 House Report as the Ninth Circuit essentially did.

(ii) Upon a request for rehearing, the court adhered to its decision. In denying that request, the court held that its decision was in accord with *In re Century Bass Products, Inc.*, 22 F.3d 37 (2d Cir. 1994). In that case, the Second Circuit rejected the “literalist” approach as it applied to the statute of limitations for a debtor-in-possession, finding that no trustee needed to be appointed to trigger the start of the two-year period. Instead, the Second Circuit focused on the “substantive limitation set forth in the statute as applied to the *debtor in possession*” and recognized the result could vary when applied. Building on that premise, the bankruptcy court in *Footstar* noted that, with respect to Section 365(c)(1), no deviation from the literal language was even required, for the reasons outlined in its decision. *Id.* at 577-78.

F. *The Impact of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA)*

1. **Unenacted Provisions**. Prior versions of BAPCPA included language that would have permitted assumption of executory contracts by a debtor even where assignment was prohibited.

a) The version of the Bankruptcy Reform Act proposed in 1999 included the following addition to Section 365(c).

(2) Notwithstanding paragraph (1)(A) and applicable nonbankruptcy law, in a case under chapter 11 of this title, a trustee in a case in which a debtor is a corporation, or a debtor in possession, may assume an executory contract or unexpired lease of the debtor, whether or not the contract or lease prohibits or restricts assignment of rights or delegation of duties.

H. Rep. No. 106-123 (Apr. 29, 1999). That amendment was described in legislative history in the following manner:

Section 305. Permitting assumption of contracts.

Section 365(c)(1) of the Bankruptcy Code prohibits a trustee from assuming or assigning a contract that is, by its terms, personal to the debtor and thus, under applicable nonbankruptcy law, nonassignable. Section 305 makes a technical correction to Section 365(c) of the Bankruptcy Code to clarify that in a corporate chapter 11 case the trustee or debtor in possession may assume an executory contract or unexpired lease of the debtor, whether or not the

contract or lease prohibits or restricts assignment of rights or the delegation of duties.

Id.

b) In 2003, the version of the Bankruptcy Reform Act considered by Congress included language different than the earlier version, but that expressly allowed assumption by a debtor-in-possession (but not a trustee) even where assignment was prohibited:

(2) A debtor in possession may assume, but may not assign, an executory contract or unexpired lease in the circumstances described in paragraph (1)(A).

H.R. Rep. 108-42; 149 Cong. Rec. H 2055-02, at 2068.

c) BAPCPA does not, as enacted, include any provision comparable to those considered in prior versions of the legislation.

2. The fact that BAPCPA does not include any of the provisions considered prior to its enactment could be construed to support an argument that the “plain meaning” interpretation of Section 365(c)(1) adopted in *Catapult* and a majority of decisions from Courts of Appeals, reflects the intent of Congress. On the other hand, it could be argued that Congress, following the majority rule and/or the rationale of *Footstar*, viewed the current language as sufficient to permit application of the “actual test.”

**G. *Does Exclusivity Lead to A Different Result?
Does the Nature of the Intellectual Property Make a Difference?***

1. **Exclusive Patent Licenses**. Does it make a difference if the patent license at issue is an *exclusive* license?

a) Arguably yes, as exclusive licenses have some indicia of ownership, and may provide the licensee with an equitable interest sufficient to provide standing in litigation regarding the patent.

b) The Ninth Circuit left open the issue in *Catapult*, 165 F. 3d at 750 n.3 (“we express no opinion regarding the assignability of exclusive patent licenses under federal law . . .”).

c) At least one Bankruptcy Court, however, has found that the exclusivity of a patent license did not exclude the license from the reach of Section 365(c). *Hernandez I*, 285 B.R. 435 (standing to sue to protect against infringement of an exclusive patent license does not correlate to the assignability of such patent). In *Hernandez*, the Court held that a DIP’s assumption of the license “would create a situation where a patent holder loses control over the identity of its license holders whenever the license agreement provides a licensee with an exclusive right. Such a result, which effectively treats the grant of an exclusive license as the equivalent of an

outright assignment of the Patent, is inconsistent with federal case law which carefully distinguishes between the two.” *Id.* at 439-40.

2. Copyright Licenses

a) Ninth Circuit – Neither Non-Exclusive Nor Exclusive Licenses May Be Assumed: The Ninth Circuit recently held that, as with non-exclusive licenses, the Copyright Act prohibits a licensee under an exclusive copyright license from assigning the license without consent. *Gardner v. Nike, Inc.*, 279 F. 3d 774, 777-81 (9th Cir. 2002); see *Harris v. Emus Records Corp.*, 734 F. 2d 1329 (9th Cir 1984) (same result under prior law). As a consequence, under *Catapult*, even exclusive licenses likely may not be assumed by a DIP.

b) Other Courts. Other courts that follow the “hypothetical test” reject *Gardner* and draw a distinction between non-exclusive and exclusive copyright licenses, holding that non-exclusive licenses may not be assumed but that exclusive licenses may be assumed.

(i) *Compare Golden Books I*, 269 B.R. at 308-10 (a non-exclusive copyright license may not be assumed) with *In re Golden Books Family Entertainment Inc.*, 269 B.R. 311, 318-19 (Bankr. D. Del. 2001) [*Golden Books II*] (concluding that, under section 201(d) of the Copyright Act, “exclusive licensees have the right to freely assign their rights” and that, as a result, a DIP may assume an exclusive license).

(ii) *See Patient Education*, 210 B.R. at 242 (holding that the DIP may not assume a non-exclusive copyright license), and at 240 (in dicta, stating that exclusive licenses are assignable under federal copyright law).

3. Trademark Licenses

a) Unlike patents and copyrights, there is no exclusive federal jurisdiction over trademarks. Even though federal trademark registrations are a creation of federal law under the Lanham Act (15 U.S.C. § 1051), trademark rights arise from use, not registration, and the federal registration system is an overlay on common law and state registration systems. Unlike a copyright (which is an affirmative right to make copies, distribute, perform etc. a work of authorship) and patents (the power to exclude others from using or making a process or device), a trademark is only “an identifier rather than a property ‘right,’” *Dorr-Oliver, Inc. v. Fluid-Quip, Inc.*, 94 F. 3d 376, 380 (7th Cir. 1996).

b) Based on this, at least one court has held that “the grant of a non-exclusive [trademark] license is ‘an assignment in gross,’ that is, one personal to the assignee and thus not freely assignable to a third party . . . , a licensor need not accept performance from or render performance to an entity other than the licensee.” *Travelot*, 286 B.R. at 455. As a consequence, courts adopting the “hypothetical test” likely would hold that a DIP may not assume a nonexclusive trademark license agreement. *Id.*

c) A different result could be reached for an exclusive trademark license. In *NCP Marketing Group*, 2005 WL 3253268, the district court found that consent to “assignment” of a non-exclusive assignment was not, under “doctrine of invisibility” that applies to both copyrights and trademarks, a right to “assign” rather than just license the trademark. Such a right of assignment requires having an “exclusive license” which includes the exclusive ownership and good will.

4. **Combined Exclusivity and Consent**

a) Under the reasoning of *NCP Marketing Group*, exclusivity could make a difference in determining whether “consent” to assignment (discussed *infra*) can overcome the restrictions on assumption otherwise imposed by Section 365(c)(i) in *Catapult*.

H. ***Ramifications Of An Inability To Assume A License – Can The License “Ride Through”? Can The Licensor’s “Consent” Save The Day?***

1. **Generally.** A license of intellectual property may be a critical asset and essential to the ongoing operation of the enterprise. Without some licenses, reorganization may be impossible. Does *Catapult* doom these cases to failure?

2. **In re Hernandez, 287 B.R. 795, 799 (Bankr. D. Ariz. 2002) [Hernandez II].** Addresses a possible way out of the dilemma.

a) In *Hernandez I*, the court held that the debtor could not assume a valuable exclusive patent license. *Hernandez I*, 285 B.R. 435.

b) In *Hernandez II*, recognizing that “there will be no reorganization” without the license, the court considered whether rejection of the license was required upon the determination that the license could not be assumed. Ultimately, the court concluded that the license could “ride through” the bankruptcy case without being assumed or rejected, even where the non-debtor licensor filed a motion under Section 365(d)(2) of the Bankruptcy Code to compel the debtor to reject.

(i) Initially articulated by the Fourth Circuit in 1936, the “ride through” doctrine stands for the proposition that an “executory contract remains in full force until rejected, and unless rejected it passes through with other property of debtor to reorganized corporation.” *Consolidated Gas, Elec. Light and Power Co. v. United Railways and Elec. Co.*, 85 F. 2d 799, 805 (4th Cir. 1936); *In re Polystat, Inc.*, 152 B.R. 886, 890 (Bankr. E.D. Pa. 1993) (“In a chapter 11 case, where a debtor has failed to expressly assume or reject a prepetition lease agreement or executory contract, that lease or contract will be unaffected by the bankruptcy filing.”); *In re Day*, 208 B.R. 358, 368 (Bankr. E.D. Pa. 1997) (same).

(ii) “Ride through” is not equivalent to assumption. If a contract is not assumed or treated in a bankruptcy case, the DIP cannot take advantage of the benefits of Section 365, such as curing defaults and nullifying bankruptcy *ipso*

facto clauses. The DIP also cannot discharge claims arising from the contract. *Hernandez II*, 287 B.R. at 801 n.8.

3. **Consent to Assignment.**

a) Section 365(c)(1) is phrased in the conjunctive – i.e. it applies if and only if both parts (A) (the contract is personal) and (B) (no consent is given) are satisfied. That is, if *either* the non-debtor party to a contract could be compelled to accept performance under the contract from a party other than the debtor or the debtor in possession, *or* the non-debtor party consents, then Section 365(c)(1) is inapplicable and the debtor’s powers of assumption under Section 365(a) and assignment under Section 365(f) are unaffected.

(i) As discussed above, federal patent law applies when the executory contract in question is a patent license, and federal patent law holds that a patent license is deemed personal and non-assignable. However, federal patent law also “carries with it the convention that if there are ‘express words to show an intent to extend the right to an assignee’ the license may be assigned. Therefore, if such words exist within the license itself, applicable law would not excuse the licensor from accepting or from rendering performance to such an assignee.” *In re Supernatural Foods, LLC*, 268 B.R. 759, 804-05 (Bankr. M.D. La. 2001) *quoting* *Oliver v. Rumford Chemical Works*, 109 U.S. 75, 81-82, 3 S.Ct. 61 (1883).

(ii) Thus, if (a) a patent license or similar contract contains language permitting its assignment to a third party without restrictions as to the personal identity of that assignee, then (b) applicable law does not excuse the licensor from accepting or from rendering performance to a party other than the debtor or the debtor in possession. In that event, as discussed above, Section 365(c)(1)(A) does not apply and thus Section 365(c)(1) does not act to limit a debtor’s powers of assumption or assignment.

(iii) Courts have found that “pre-consents” to assignment of a patent license, when not tied to the identity of the assignee, effectively constitute a *waiver* of any right a patent licensor may have to object to assumption and assignment of a patent license based upon the identity of the transferee. *See, e.g., In re Hernandez*, 285 B.R. 435, 441 (Bankr. D. Ariz. 2002) (“In consenting to assignment in such situations, the non-debtor parties to the contracts gave up any interest in the identity of the assignees, thereby effectively removing the contracts from the protections otherwise afforded to them under ‘applicable law’ and § 365(c)(1), to control the identity of assignees.”), *citing* *Cyrix Corp. v. Intel Corp.*, 803 F. Supp. 1200 (E.D. Tex. 1992), *In re Midway Airlines, Inc.*, 6 F. 3d 492 (7th Cir. 1993) and *In re Supernatural Foods, LLC*, 268 B.R. at 804-05 (provision in a patent license providing the debtor with the ability to assign the license “incident to the sale of the substantial portion of [the debtor]’s assets” was a sufficient expression of consent to enable the debtor to assume a patent license in connection with such a sale notwithstanding Section 365(c)(1)). *Id.* at 804-05.

(iv) The Fourth Circuit, on the other hand, while citing and acknowledging all of the foregoing authority, has held to the contrary. In *Sunterra Corp.*, 361 F.2d at 270-71, the Fourth Circuit considered whether consent under a license to assignment by the debtor to a successor in interest who acquires substantially all of the debtor's assets could permit assumption or assignment. On the one hand, the Fourth Court Circuit found the contractual provision to be "relevant." At the same time, because the provision did not also reference "assumption," and applied "exclusively to assignments," the Fourth Circuit held that the consent did not apply to assumption. *Id.* at 271. In so holding, the Fourth Circuit distinguished *In re Midway Airlines*, 6 F.3d 492 (7th Cir. 1993), which contained a provision that explicitly contemplated "assumption and assignment in the bankruptcy context."

(v) In *Hernandez I*, 285 B.R. at 441-42, the bankruptcy court also held that pre-bankruptcy consent to assignment to an entity owned by the debtor was not alone sufficient to remove the agreement from the reach of Section 365(c)(1) as interpreted by *Hernandez*. The court based this ruling on the fact that, without Section 365(c)(1), the license would only be "viewed through the lens of Section 365(f)(1), which clears the field of any purported restriction on the trustee's right to assign." *Id.* at 441. The court was thus unwilling to interpret pre-bankruptcy consent to assignment parties to overcome any restriction on assignment that would otherwise apply to such other parties.

b) Similarly, under the "hypothetical" test, Section 365(c)(1) should be equally applicable to both the power of assumption under Section 365(a) and the power of assignment under Section 365(f), and without regard to the actual identity of the party who ultimately will be rendering or accepting performance under the agreement.² Because Section 365(c)(1) acts merely as a limitation on both the power of assumption and assignment, then it is clear that if it does not apply – i.e. if applicable law would *not* excuse a non-debtor party from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession *or* if the non-debtor party consents – then it is equally inapplicable as a limitation on either of those powers. In other words, if applicable law would require the non-debtor party to accept performance from a party other than the debtor, then it must also accept performance from the debtor.

(i) No court has yet gone so far. However, courts applying the hypothetical test in similar circumstances have noted that a debtor would "prevail" thereunder – i.e. not be barred from assuming or assigning a contract – if they could demonstrate that "federal patent law would require the [non-debtor]

² In contrast to other Circuits, where the "actual" identity of the party who will continue performing under the contract is material to the analysis, the Ninth Circuit applies a "hypothetical" test to *both* assumption and assignment. Again, this is based strictly upon the specific language of Section 365(c)(1) – because the provision says that a debtor may not assume *or* assign, the limitation is deemed applicable to both powers if both Sections 365(c)(1)(A) and (B) are satisfied.

Licensor to accept performance from, and render performance to, a party different from [the debtor].” *In re Hernandez*, 285 B.R. 435, 440 (Bankr. D. Ariz. 2002).

c) Another issue on consent is whether consent may be assumed from silence or upon negative notice. Many local bankruptcy rules permit a motion to be granted by default against a party who received proper notice. It is becoming increasingly common for courts to approve the use of these provisions to presume consent to assumptions or assignments of contracts that would otherwise be non-assumable or non-assignable under Section 365(c)(1).

II. Debtors Who Are Licensors Of Intellectual Property – The Uncharted Territory Of Section 365(n)

A. *The Issue – Possibly Catastrophic Impact Of Rejection of the License*

1. **Lubrizol**. In *Lubrizol*, a debtor-licensor sought to reject a nonexclusive patent license agreement governing the use of its metal coating process technology. *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.)*, 756 F. 2d 1043 (4th Cir. 1985). The Fourth Circuit affirmed rejection as a proper exercise of the debtor’s business judgment irrespective of the fact that such finding acted to cut off the licensee’s rights under the nonexclusive patent license agreement and caused potentially irreparable to the non-debtor licensee. *Id.* at 1047-48.

2. 365(n) – The Response To Lubrizol

a) In 1988, in response to *Lubrizol*, Congress enacted Section 365(n) of the Bankruptcy Code.

b) Generally, Section 365(n) provides that, upon rejection of an executory contract under which the debtor is a licensor of a right to intellectual property, the licensee “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; or (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 (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. *Section 365(n) In Practice*

1. **Intellectual Property**. Section 365(n) only applies to contracts under which the Debtor is a *licensor* of “intellectual property,” and only to “intellectual property” as defined under section 101(35A) of the Bankruptcy Code.

a) Copyrights and patents are included in the definition found in section 101(35A).

b) Trademarks are not included and not protected by Section 365(n). *In re Centura Software Corporation*, 281 B.R. 660, 671-75 (Bankr. N.D. Cal. 2002) (finding that “§ 365(n) plainly excludes trademarks”); *Licensing by Paolo, Inc. v. Sinatra (In re Gucci)*, 126 F. 3d 380, 394 (2d Cir. 1997).

(i) *Cf. In re Matusalem*, 158 B.R. 514 (Bankr. S.D. Fla. 1993) (refusing to authorize the debtor’s rejection of a trademark license, where rejection would provide no economic benefit to the estate but would destroy the licensee’s business).

c) Section 365(n) protects and preserves only those rights of a non-debtor party as they existed “as of the commencement of the bankruptcy case.” *See, e.g., In re Storm Technology, Inc.*, 260 B.R. 152, 157 (Bankr. N.D. Cal. 2001). Thus springing or other contingent licenses or rights to obtain licenses are at risk if the licensor files bankruptcy.

2. **Retention of Rights.** If the licensee elects to “retain its rights,” the rights are only to intellectual property as it existed on the petition date. 11 U.S.C. § 365(n)(1)(B) (protection given to licensee’s rights to intellectual property “as such rights existed immediately before the case commenced”); S. Rep. No. 100-505, at 8-9 (1988) (the rights of a licensee who exercises its option under Section 365(n)(1)(B) “are only in the underlying intellectual property as it existed at the time of the filing”) (also noting that a licensee who elects to retain its rights “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); *Biosafe Int’l, Inc. v. Controlled Shredders, Inc. (In re Szombathy)*, 1996 WL 417121 (Bankr. N.D. Ill. 1996) (licensee not entitled to any modifications or improvements in debtor’s patented tire shredders created after petition date).

a) This limitation may severely impact a licensee where the licensor’s intellectual property remains uncompleted as of the petition date or is subject to continuing postpetition upgrades.

3. **Licensee Performance.** After a nondebtor licensee makes an election to “retain its rights” under Section 365(n), the licensee must continue to make royalty payments, without regard to any right of setoff possessed by such licensee. 11 U.S.C. § 365(n)(2)(B)-(C).

a) Query whether the licensee retains rights of recoupment even if setoff rights are prohibited.

b) What is a “royalty payment”? *Prize Frize*, 32 F. 3d at 428-29 (defining the term “royalty payments” broadly to include any payment due for the use of the intellectual property, regardless of the nomenclature used to characterize the payment).

4. **Debtor’s Other Ongoing Obligations Terminated.** The licensee does not have the right to seek specific performance of contractual obligations from the debtor-licensor once a

Section 365(n) election is made. Rather, all that the licensee can do is to demand that the DIP, to the extent provided in the contract, “provide to the licensee any intellectual property (including such embodiment) held by the trustee.” 11 U.S.C. § 365(n)(3)(A).

a) Accordingly, under Section 365(n)(3)(A), the licensee may request that the DIP provide the licensee access to the source code of a software program if such access was provided for under the terms of the contract.

b) In addition, Section 365(n)(3)(B) allows the licensee to request in writing that the licensor “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)(3)(B).

(i) Thus, with proper foresight, this provision could provide a licensee with access to escrowed source code and related embodiments.

III. Considerations in the Purchase of Assets from Bankruptcy Estates, or “The Curious Case of the Cross-License”

A. *Diligence – Identifying the Nature and Transferability of IP Assets.*

1. **Finding the IP.** A DIP’s business operations can include obvious intellectual property such as patents, copyrights and intellectual property, as well as less obvious forms such as customer lists, business methods or other trade secrets, or even mixed elements such as embedded software or marketing materials. It is important not to underestimate the scope of this inquiry – intellectual property rights may be implicated not only on big picture items, such as trademarks, core copyright or patent assets and the like, but also in smaller items, including site licenses for computer software, IP phones or other transparent items.

2. **Determining Scope of Ownership.** The DIP may own the intellectual property (registered patents, etc.), or it may merely hold it under a license. As discussed above, license rights may or may not be transferable by a DIP and a purchaser may be forced to negotiate with third party software vendors (think Microsoft, Adobe, etc.) for new licenses following the acquisition.

3. **Determining Prior Claims.** The DIP’s intellectual property, just like its other property, may be subject to liens or other clouds on title. Moreover, intellectual property may be subject to exclusive or non-exclusive license rights granted to third parties. Determining the scope of such licenses is complicated, as non-exclusive patent and copyright licenses need not be registered with any filing or recording office and, like adverse possession, may even arise without a formal written grant by the owner.

B. *Mechanics – Dealing with 365(n) Rights.*

1. **ad hoc Procedures.** While unusually explicit concerning the effects of electing to retain license rights, Section 365(n) and the Bankruptcy Rules are silent with respect to mechanics. Unlike proofs of claim then (the closest analog to a 365(n) election, with well

established rules, deadlines, procedures and even forms), courts typically address 365(n) procedures on an ad hoc basis. In light of this, in any case where a motion is filed to reject contracts that may include licenses or inchoate rights (such as license by estoppel or implication) in the DIP's intellectual property – especially in omnibus rejection contexts such as Chapter 7 cases or liquidating Chapter 11 plans – it is important to establish clear procedures and deadlines requiring non-debtor parties to assert license rights by a date certain.³

2. **Deemed Consent.** As discussed above, many local bankruptcy rules permit a motion to be granted by default against a party who received proper notice, and these provisions are often used to presume consent to assumptions or assignments of contracts that would otherwise be non-assumable or non-assignable under Section 365(c)(1). A similar argument applies on the ad hoc procedures setting election bar dates.

3. **Free and Clear.** Outside the bankruptcy world, non-exclusive patent and copyright licenses encumber intellectual property assets even after a transfer. However, bankruptcy sales are well known for the ability to sell “free and clear” of liens and other interests. No court has squarely addressed the issue, but dicta from cases under 365(h) – a provision similar to 365(n) applicable when the DIP is a lessor of real property – indicates that it may be possible to strip off licenses of non-objecting third parties with notice of a sale free and clear of their interests. *See Precision Industries, Inc. v. Qualitech Steel SBQ, LLC*, 327 F.3d 537, 545 (7th Cir. 2003).

4. **Assumption of 365(n) Obligations.** If a sale cannot be accomplished free and clear of licenses or at least 365(n) rights to retain licenses, purchasers are effectively if not explicitly burdened with the assumption of obligations that Section 365(n) would otherwise impose on DIPs or trustees.

a) **Obtain Monetary Rights.** Given the purchaser's obligations to conform with Section 365(n)'s obligations, it is important for purchasers to clarify in the APA and the sale order that any attendant counterclaims or rights shall also go to the purchaser, regardless of where they arise. Of particular concern are royalties. In *In re Cellnet Data Systems, Inc.*, 327 F.3d 242, 251 (3rd Cir. 2003), the Third Circuit determined that a royalty stream was severed from the ownership of the underlying intellectual property when the purchaser did not assume a license agreement with a third party who had elected to retain license rights under Section 365(n). Put another way, the purchaser was obliged to honor the third party's license, but the bankruptcy estate was entitled to reap the royalties. The Third Circuit implied without holding that this result could be reversed by clear contractual language.

b) **Obtain Standing.** It is also important for purchasers to clarify in the APA and the sale order that the purchaser shall have the right to object to any elections under Section 365(n), avoiding a situation where the trustee may wish to enter into a litigation-avoidance settlement that would undercut the purchaser's rights.

³ Suggested language for inclusion in rejection orders is attached as Exhibit II hereto.

5. **Beware the Cross License.** Of particular concern to purchasers of intellectual property from DIPs (as well as DIPs themselves in jurisdictions that apply the “hypothetical test” of *Catapult*) is the cross-license.

a) **The Issue.** Cross-licenses are often entered into by companies with massive competing patent portfolios as a litigation settlement device and can be compared to a truce. However, (i) the DIP’s license-out is preserved as against the purchaser for the benefit of the licensee under Section 365(n) but (ii) under Section 365(c)(1) the licensee can veto the transfer of the DIP’s license-in to the purchaser (and in *Catapult* jurisdictions it can veto even the DIP’s assumption of that license in a reorganization. It would thus appear that a purchaser of a DIP’s intellectual property assets that are subject to a cross-license is faced with the worst of both worlds – as in *Cellnet*, the purchaser must suffer a third-party license on its valuable property but risk receiving nothing in return.

b) **Deemed or found consent as a solution.** Any solution that would work in the context of Section 365(c)(1) discussed above – deemed consent, broad assignability provisions and the like – would prevent this draconian result.

c) **Broad royalties as a solution.** Although Section 365(n) provides that any “royalty” due for the use of intellectual property following a 365(n) election is to be paid to the trustee, *Cellnet* appears to make clear that such royalty may be assigned to the purchaser contractually, even if the underlying agreement by which it arises is not transferred. Moreover, in the bankruptcy context, the term royalty is very broad and encompasses any and all compensation or consideration due for a license, regardless of form or denomination. *See, e.g., In re Prize-Frize, Inc.*, 150 B.R. 456, 460 (9th Cir. BAP 1993), *aff’d* 32 F. 3d 426 (9th Cir. 1994) (“[T]his term encompasses any payment for use of intellectual property, no matter how that payment is named in the agreement. ... If this were not the case, licensees would be allowed to continue to use property of the estate without compensating the estate.”). As noted in the legislative history, “It is important that courts, in construing the term ‘royalty’ used in this subsection, ... look to the substance of the transaction and not the label.” *Id.* at 459-60, *quoting* H.R. Rept. No. 1012 at 9, 100th Cong., 2nd Sess. (1988). In the case of the cross-license, then, an argument could be advanced that the consideration the non-debtor licensee must provide as “royalty” is in fact the reciprocal license that would be called for by the cross-license.

6. **Trademark Issues.**

a) **Precatory language.** Transfers of trademark rights are of particular concern to purchasers of a DIP’s assets. It is well settled that trademark rights arise from use, and may only be transferred together with the goodwill they represent. Thus, as with a purchase outside of bankruptcy, it is necessary to ensure that “goodwill” is specifically included as a purchased asset.

b) **Intent to use applications.** With respect to a DIP’s live trademark registration applications, in most cases, a purchaser will be able to acquire only applications based upon the debtor’s prior use of the mark. An intent-to-use application

may be assigned only to a successor to the trademark applicant's business except where a statement of use has been filed with the PTO attesting that the proposed mark is being used in commerce. A DIP, in the process of winding down or having suspended operation, may not have begun using its marks, in which case an assignment of the debtor's intent-to-use trademark applications will be void.

c) Bankruptcy language. As with intent-to-use applications, third party intervenors may claim after the fact, particularly in the case of non-operating or liquidating DIPs, that the "goodwill" transferred to the purchaser is in fact meaningless since the trademark did not at such time represent any goodwill. Accordingly, especially in cases where the trademark is valuable and/or the DIP is non-operational, it is important to include in the sale order specific language validating the transfer of the property as valid, vesting in the purchaser all right, title and interest in and to the mark. It is also a good idea in this respect to ensure that the APA is structured as a sale of all of the DIP's assets subject to carveout, rather than a specific enumeration of purchased assets. Ensuring that the purchase of the goodwill represented by the DIP's business is more than a precatory recitation should strengthen the defense to any later attack.

d) Name change. As trademark rights arise from use, it is also important to ensure that the DIP agrees in the APA to change its name and to refrain from using that name or the mark in commerce following the sale.

IV. Debtors As Owners of Intellectual Property – Avoidance Of Security Interests In I.P.

A. *The Issue – Use Of Bankruptcy To Avoid Security Interests In Intellectual Property*

1. **Background**. Upon the commencement of a chapter 11 case, the DIP has certain "avoiding powers," which include the power to set aside unperfected or late-perfected security interests in the debtor's property for the benefit of the bankruptcy estate. 11 U.S.C. §§ 544(a), 547, 548, 550. Although the order of priority in encumbered personal property generally is dictated by Article 9 of the UCC or other applicable nonbankruptcy law, the Bankruptcy Code determines the DIP's status in the state law hierarchy. Section 544(a)(1) (aka the "strong arm clause"), for example, gives the DIP the rights and powers, as of the petition date, of a judicial lien creditor with respect to encumbered personal property. 11 U.S.C. § 544(a)(1) ("The trustee shall have . . . the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by . . . a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists.").

B. Copyrights – A bankruptcy filing by an owner of registered copyrighted material may result in the avoidance of security interests in that material if the secured creditor has not properly recorded its interests with the United States Copyright Office.

1. **Registered Copyrights – National Peregrine.**

a) A security interest in a copyright is a “transfer of copyright ownership” for purposes of the recording provisions of the Copyright Act. 17 U.S.C. § 101 (a “transfer of copyright ownership” includes “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,” but does not include a nonexclusive license).

b) To perfect a security interest in a registered copyright, the creditor must record the interest with the Copyright Office in accordance with section 205 of the Copyright Act. 17 U.S.C. § 205(d); *National Peregrine, Inc. v. Capitol Federal Sav. & Loan Ass’n*

(*In re Peregrine Entertainment, Ltd.*), 116 B.R. 194, 201-03 (C.D. Cal. 1990)

(“Recording in the U.S. Copyright Office, rather than filing a financing statement under Article Nine, is the proper method for perfecting a security interest in a copyright.”).

(i) The recordation provisions of the Copyright Act preempt general state law filing and recordation laws. *National Peregrine*, 116 B.R. at 198-203.

(ii) Thus, if not recorded with the Copyright Office, the security interest may be avoided. In *National Peregrine*, the debtor sought to avoid a security interest in certain of the debtor’s collateral, including a library of copyrights, distribution rights and licenses to approximately 145 motion pictures, in which the debtor’s predecessor had granted a security interest in connection with a \$6 million line of credit. *Id.* at 197-98. The secured lender filed UCC-1 financing statements in California, Colorado and Utah. The lender, however, “did not record its security interest in the United States Copyright Office.” *Id.* at 198. Based on the secured creditor’s failure to record its security interest with the Copyright office, the District Court (Judge Kozinski, sitting by designation) determined that the secured creditor’s security interest was unperfected. *Id.* at 198-204. Judge Kozinski held that, pursuant to section 544(a), the secured creditor’s “unperfected security interest in [the debtor’s] copyrights and the receivables they generated is trumped by [the debtor’s] hypothetical judicial lien.” *Id.* at 207.

(iii) *National Peregrine*’s conclusion with respect to registered copyrights was endorsed by the Ninth Circuit in *Aerocon Engineering, Inc. v. Silicon Valley Bank (In re World Auxiliary Power Co.)*, 303 F. 3d 1120, 1128 (9th Cir. 2002) (“For registered copyrights, the only proper place to file is the Copyright Office. We adopt *Peregrine*’s holding to this effect.”).

2. **Unregistered Copyrights – World Auxiliary.**

a) Copyrights need not be registered with the Copyright Office to provide protection to the author. However, registration is a prerequisite to enforcement through a suit for infringement. 17 U.S.C. § 411(a).

b) In *Aerocon Engineering, Inc. v. Silicon Valley Bank (In re World Auxiliary Power Co.)*, 303 F. 3d 1120 (9th Cir. 2002), the Ninth Circuit held that a security interest in unrecorded copyrighted material could (indeed, must) be perfected by following state law UCC procedures. *Id.* at 1125-32. Thus, the Court held that a debtor could not avoid a secured creditor's security interest in unregistered copyrights where the creditor had not recorded with the Copyright Office but had filed a timely UCC-1.

(i) *World Auxiliary* rejects previous decisions on this issue, which applied *National Peregrine* to unregistered copyrights. *See In re Avalon Software*, 209 B.R. 517, 521 (Bankr. D. Ariz. 1997) (holding that DIP could avoid a security interest in copyrighted and copyrightable computer software and the proceeds thereof where secured lender failed to record the transfer in the Copyright Office); *Official Unsecured Creditors' Comm. v. Zenith Prod. Ltd. (In re AEG Acquisition Corp.)*, 161 B.R. 50, 57-8 (9th Cir. B.A.P. 1993) (perfection of security interest in foreign motion picture requires filing in Copyright Office, even if no copyrights had been registered).

(ii) Prior to *World Auxiliary*, a secured party was required to ensure that the debtor registered the copyrighted material with the Copyright Office prior to recording the security interest with the Copyright Office. *Avalon Software*, 209 B.R. at 521. The burden also was on the secured party to ensure that the debtor registered any and all intellectual property that might conceivably fall within the scope of the copyright laws (including derivative works) in which the secured party sought a security interest. *Id.* at 522. It also followed that secured parties had to continue to monitor the copyright registration activities of a borrower to ensure that all intellectual property continued to be subject to their security interest.

3. **Ramifications of Avoidance – Impact on Receivables.**

a) If a security interest in a copyright is avoidable, the accounts receivable generated by licensing the copyright also are vulnerable, even if appropriate measures are taken to file a UCC financing statement with respect to the receivables. *National Peregrine*, 116 B.R. at 204 (“Cap Fed’s security interest in the copyrights of the films in NPI’s library and the receivables they have generated therefore is unperfected.”); *Avalon Software*, 209 B.R. at 523-24.

b) *Cf. Broadcast Music, Inc. v. Hirsch*, 104 F. 3d 1163, 1166 (9th Cir. 1997) (no requirement of recordation/perfection for a lender who enters into agreement providing for the outright assignment of right to receive royalties generated from

copyrighted materials).

C. *Patents*

1. **No Federal Recordation System**. Unlike with registered copyrights, filing in the Patent and Trademark Office is not necessary to perfect a security interest in a patent. *Moldo v. Matsco, Inc. (In re Cybernetic Services, Inc.)*, 252 F. 3d 1039, 1045-59 (9th Cir. 2001).

2. Thus, security interests in patents may be perfected by filing financing statements in compliance with the UCC. *Cybernetic Services*, 252 F. 3d at 1059; *City Bank & Trust Co. v. Otto Fabric, Inc.*, 83 B.R. 780, 781 (D. Kan. 1988) (recordation in the Patent and Trademark Office pursuant to 35 U.S.C. § 261 was unnecessary to perfect security interest in patent as against the trustee in bankruptcy); *In re Transportation Design & Technology, Inc.*, 48 B.R. 635, 638-89 (Bankr. S.D. Cal. 1985) (concluding that 35 U.S.C. § 261 did not supplant the UCC provisions for perfecting security interests in patents).

D. *Trademarks*

1. **No Federal Recordation System**. As with patents, it has been held that there is no federal system of recordation of trademarks.

a) The Lanham Act provides that “an assignment shall be void as against any subsequent purchaser for a valuable consideration without notice, unless it is recorded in the Patent and Trademark Office within three months after the date therefor or prior to such subsequent purchase.” 15 U.S.C. § 1060.

b) However, courts hold that the purpose of the Lanham Act is to protect the public from the deceptive use of trademarks and that, in enacting the Lanham Act, Congress did not intend to provide a method of perfecting security interest in trademarks or trade names. *Creditor’s Comm. Of TR-3 Indus., Inc. v. Capital Bank (In re TR-3 Indus., Inc.)*, 41 B.R. 128, 131 (Bankr. D.C. Cal. 1984) (“It was not the purpose or intent of Congress in enacting the Lanham Act to provide a method for the perfection of security interests in trademarks, tradenames or applications for the registration of the same, or as a method for giving notice of the existence of a claim of a security interest therein.”).

c) Thus, in *Roman Cleanser Co. v. National Acceptance Co. (In re Roman Cleanser Co.)*, 43 B.R. 940, 946 (Bankr. E.D. Mich. 1984), *aff’d mem.*, 802 F. 2d 207 (6th Cir. 1986) (filing of an appropriate UCC-1 Financing Statement sufficient to perfect security interest in registered trademark), the Bankruptcy Court determined that “an assignment” is not the equivalent to a security interest in a trademark since Congress specifically excluded the term “security interest” from section 1060. In addition, the Bankruptcy Court found that “[s]ince a security interest in a trademark is not equivalent to an assignment, the filing of a security interest is not covered by the Lanham Act. Accordingly, the manner of perfecting a security interest in trademarks is governed by Article 9 and not by the Lanham Act.” *Id.* at 944.

d) Other courts similarly have determined that a security interest in a trademark is perfected upon the filing of a financing statement in compliance with Article 9 of the UCC. *Joseph v. 1200 Valencia, Inc. (In re 199Z, Inc.)*, 137 B.R. 778, 782 (Bankr. C.D. Cal. 1992) (holding that a security interest in a trademark was not perfected by recordation in the Patent and Trademark Office); *TR-3 Indus*, 41 B.R. at 131-32 (security interest in trademarks perfected by filing UCC-1 Financing Statement); *Trimarchi v. Together Development Corp.*, 255 B.R. 606 (D. Mass. 2000) (security interest in trademark found to be unperfected by company who filed UCC-1 Financing Statement with the Patent and Trademark Office, because Lanham Act did not create an exemption from state and local filing requirements).

Exhibit I

Intellectual Property Primer

I. Intellectual Property: What Is It, What Can You Do With It And What Does A Bankruptcy Lawyer Need To Know About It?

A. Generally. “Intellectual property” refers to intangible creations of the human mind in which existing law recognizes a property right. These property rights fall into two broad categories – invention protection rights and market protection rights. Invention protection is available for new products, processes and works of authorship, such as an electronic mail system with RF communication to mobile processors (commonly known as a “Blackberry” device), a software application and a musical composition. Patents, copyrights and the laws prohibiting misappropriation of trade secrets are the principal forms of legal protection of inventions and creative works. Market protection relates to name recognition and the identification of goods and services in the marketplace. Trademarks, unfair competition laws and rights of publicity provide market protection for a product name, such as “Blackberry,” and the use of an individual’s persona in marketing a product or service.

i. Definition of “Intellectual Property”. “Intellectual property” is defined in Section 101(35A) of the Bankruptcy Code to mean:

1. trade secrets;
2. inventions, process, designs or plants protected under Title 35 of the United States Code;
3. patent applications;
4. plant varieties;
5. works of authorship protected under Title 17 of the United States Code; and
6. mask works protected under Chapter 9 of Title 17 of the United States Code.

ii. “Intellectual property” under the Bankruptcy Code does not include trademarks, domain names, trade dress or rights in data or databases.

B. Statutory Rights.

i. Patents. A U.S. patent is a grant by the federal government to an inventor of the right to exclude others from making, using, selling, offering to sell or importing the invention claimed in the patent. Patents protect inventions, not ideas. An invention may be a new or improved product or process for making a product, a new method of doing something and a system of components, such as an electronic mail system. Software may be patentable as a product, as part of system or in terms of the functions the software performs or the process employed by the software to perform a function. Patents in effect on or issuing from patent

applications filed on or after June 8, 1995 have a term of 20 years from the original U.S. application filing date.

- 1.** Utility patents cover processes, machines, articles of manufacture, and compositions of matter and improvements of these items.
 - a.** The invention must be novel, useful and non-obvious (i.e., would not have been obvious to a person having ordinary skill in the art at the time the invention was made).
 - b.** The invention must not have been known or used by others in the U.S., or patented or described in a printed publication in any country, prior to the date of invention.
 - c.** The invention must not have been patented or described in a printed publication anywhere, or in public use or on sale in the U.S., more than 1 year prior to the filing date of the patent application.
- 2.** Design patents protect ornamental industrial designs – the aesthetic features of utilitarian articles – but not functional elements.
 - a.** The design must be new, original and non-obvious to a designer with ordinary skill in the art.
 - b.** Utility and design patents can cover different aspects of the same article.
 - c.** The duration of design patents is 14 years from the date the patent issues.
- 3.** A patent application must be filed with the U.S. Patent and Trademark Office (“PTO”) disclosing the invention in a manner that would enable a reader to use it. A “provisional” patent application may be filed with the PTO to establish the inventor’s priority based upon the filing date, but the application will be abandoned if a formal patent application is not filed within one year.
- 4.** A patent has three parts – a detailed description of the invention, drawings corresponding to the description and one or more claims. The claims define the “metes and bounds” of the patented invention.
- 5.** Infringement occurs when, in the case of a utility patent, an unlicensed product or process contains each and every element of one or more of the patent’s claims. For infringement, these elements need not be identical to those contained in the patent; under the doctrine of equivalents, infringement can result if the accused product or process performs substantially the same function, substantially the same way to obtain the same result.
- 6.** The inventor owns the patent rights in her inventions, absent an assignment. An employer that fails to obtain an assignment from an

employee may only have a nontransferable “shop right” to use the invention.

7. An assignment of ownership of a patent must be in writing. Recordation with the PTO cuts off the rights of bona fide purchasers for value without notice.
8. Patents are afforded a “presumption of validity,” but are frequently invalidated by the courts for a variety of reasons, including lack of novelty or failure to adequately disclose the invention.
9. A patent does not guarantee its owner the right to “practice” (i.e., use, make, commercially exploit) the invention. Use of an invention can subject a patent owner to liability for infringing another patent.

ii. **Copyrights.** A copyright is a federal right owned by every creator of an original literary or artistic work to exclude others from doing any of the following activities with the work: (i) reproduction, (ii) adaptation or modification, (iii) distribution to the public, (iv) performance in public or (v) display in public.

1. A copyright arises in any of the following forms of works of authorship upon being fixed in a tangible medium of expression: Literary, musical, dramatic and choreographic, pantomime, pictorial, graphic and sculptural, audiovisual and sound recordings.
2. Many elements of software applications may be protected by copyright, including graphics and text displays, game play, user interfaces, icons, logic flow and look and feel and the computer code itself.
3. Copyright only protects the expression of an idea, not the idea itself. The “idea/expression dichotomy” has limited the scope of protection available for software applications. Copyrights do not protect basic computer programming or compilations of facts.
4. Works created since January 1, 1978 are protected at the time of they are created and fixed in a tangible medium of expression (including magnetic media). Federal registration of a work is not required for copyright protection, but it is a prerequisite for filing an infringement action.
5. A copyright is initially owned by the creator of the work, unless (i) it is created by an employee within the scope of employment, (ii) the work is specially ordered or commissioned, falls within one of nine specific types of work and the parties agree in writing that the work is a “work made for hire,” or (iii) ownership of the copyright is assigned in writing.
6. A U.S. copyright in a work created after January 1, 1978 and owned by an individual has a term of the life of the author plus 50 years. If the work is a work made for hire, it has a term of either 75 years from the year of first publication or 100 years from the year of its creation, whichever expires first.
7. If a work created on or prior to January 1, 1978 and never has been published, the duration of the copyright is the same as for works created

after January 1, 1978. Prior to January 1, 1978, a copyright last 28 years from the date of registration and had to be renewed.

8. A transfer of ownership must be in writing and signed by the copyright owner. To preserve priority against third parties, the transfer must be recorded with the U.S. Copyright Office.
9. Copyright infringement occurs when one of the 5 exclusive rights is violated in connection with making an unauthorized copy of the protected work or a work that is substantially similar.
10. Copyright provides a right to exclude, but not a right to use the copyrighted work. Holding a copyright in a derivative work does not preclude infringement of the underlying work in which the derivative work is based.

iii. **Trademarks**. Trademarks are words, slogans, designs, pictures or any other symbol used to identify and distinguish goods or services in the marketplace. A trademark owner has the exclusive right to use the mark to identify all goods or services of a similar classification. In so doing, trademark law serves the public interest of ensuring purchasers that the products they purchase bearing a particular mark come from the source that the mark serves to identify and that the products will be of similar quality and have similar characteristics as other products bearing the same mark.

1. Rights in trademarks arise under the Lanham Act, by state statute or under common law within the geographic area in which the mark is used.
2. A trademark for a product in the U.S. is owned by the individual or entity that first uses the mark “in commerce” for that class of products. A trademark may be subject to the superior rights of another who previously used the same or a confusingly similar mark in commerce.
3. The rights in a trademark will exist for so long as the mark is used. Once the mark is abandoned, all rights in it can be lost and another person or entity may begin using the mark for the same class of products or services and acquire rights in the mark.
4. Improper use of one’s trademark can result in the loss of rights. A licensor of a trademark has an affirmative obligation to police the use of the licensed mark to ensure consistency in the quality of the products on which the mark is used and in the manner in which the mark is displayed.
5. A transfer of ownership of a trademark without the goodwill of the business associated with the mark invalidates the trademark.
6. If a trademark is registered under the Lanham Act or state statute, an assignment of the mark may be recorded in order to cut off the rights of bona fide purchasers for value without notice. An “intent-to-use” application for registration of a trademark cannot be assigned and may invalidate the resulting registered trademark.

7. Infringement occurs when the use of a similar mark by one with junior rights creates a likelihood of confusion.

iv. **Trade Secrets.** Information that is maintained in secrecy and provides its owner a commercial advantage because it is not generally known in the industry is a “trade secret.” This information may include technology, customer lists, and marketing plans. chemical formulas and the structure, sequence and organization of computer code within a software application.

1. Trade secrets developed by an employee within the scope of employment are owned by the employer. If the trade secret was created outside the scope of employment, then the employer may only have a “shop right” to use the information.
2. Trade secrets are protected under state law. Forty-five states have adopted the Uniform Trade Secrets Act. Protection lasts as long as the information remains a secret.
3. Trade secret law protects against misappropriation -- improperly obtaining trade secret information or using or disclosing such information without authorization. Trade secret protection does not grant any rights to exclude others from using the same information if the information was developed independently.
4. Trade secret information can be sold by assignment or licensed.

v. **Domain Names.** The first legitimate registrant of a Uniform Resource Locator has the right to use the associated name as an Internet address. Often, a company’s Second Level Domain (i.e., the words preceding the “dot” in the address) is the same as the company’s existing trademark or functions as a source identifier for the company’s products or services.

1. The Anti-Cybersquatting Consumer Protection Act imposes civil liability under the Lanham Act on anyone who registers, traffics in or uses a domain name (or a confusingly similar mark or one that is dilutive of a famous mark) with “a bad faith intention to profit” from another’s mark.
2. The Internet Corporation for Assigned Names and Numbers, which oversees the domain registration process, provides a cost-effective and expedient centralized dispute resolution procedure for domain name disputes.
3. A domain name may be sold or licensed to anyone who has the right to make use of the name’s exclusivity without infringing another’s trademark.

vi. **Publicity Rights.** The right of an individual to control the commercial use of his or her identity is recognized under the laws of some states. The scope of protection may include a person’s name, image, voice and signature.

1. Publicity rights may survive the death of the person whose persona is protected and can be transferred by assignment or license.

2. Violating a person's right of publicity occurs when their persona is used for commercial purposes without authorization.

vii. Mask Works. Mask works are the three-dimensional designs (i.e., images or templates) used to manufacture semiconductor chips. Under protection provided under the Semiconductor Chip Protection Act, the mask work owner has the exclusive right to reproduce the mask work and import and distribute semiconductor chips embodying it. However, the Semiconductor Act permits certain types of reverse engineering of protected mask works.

1. Mask works must be registered with the U.S. Copyright Office to obtain protection. Failure to register within 2 years of the date of its first commercial use will result in a loss of rights.
2. The creator of a mask work is the initial owner, except that an employer is the owner of a mask work created by an employee working within the scope of his or her employment.
3. Transfers of ownership must be in writing and may be filed with the U.S. Copyright Office. As under copyright law, recording cuts off the rights of subsequent purchasers for value without notice.

viii. Databases. Currently, there is no protection of databases under U.S. law. Recent legislation has sought to create a right in "collections of information" and to prohibit the sale or distribution of databases that have been copied or misappropriated.

C. License Agreements. A company that holds intellectual property assets will often be a party to one or more license agreements. In-bound license agreements grant the company rights in a third party's intellectual property. Out-bound license agreements are used to grant third parties rights in the company's intellectual property. Many technology companies rely upon both in-bound and out-bound license agreements to commercialize their intellectual property and operate their businesses.

- i. A software application, semiconductor or electronics device may contain embedded software code that is licensed from a third party.
- ii. A patent cross-license may be entered into enabling two patent owners to sell their inventions without violating the other's patent.
- iii. The rights granted under a license agreement may be exclusive or non-exclusive.
 1. The scope of exclusivity may be limited to one or more specific intellectual property rights, a specific geographic region, or a specific market segment or field of use.
 2. An exclusive licensee of a patent can sue for infringement in the name of the patent owner by joining the patentee as an involuntary party. An exclusive licensee of a copyright is regarded as the owner of the particular right that is exclusively licensed and has the right to sue for infringement of that right.

3. A trademark license carries no ownership right as the licensor must exercise control over the nature and quality of the goods or services sold by the licensee under the licensed mark.
- iv. The rights granted under a license agreement may be sublicenseable or non-sublicenseable or silent as to the licensee's right to grant sublicenses.
- v. The license agreement may prohibit the licensee from assigning the agreement or the rights granted under the license agreement, or both, to a third party.
 1. Assignment may be conditioned upon obtaining the licensor's prior consent.
 2. Exclusions may be provided for assignments to an affiliate of the licensee or to an acquirer of all or substantially all of the licensee's capital stock, assets or business.

D. Physical Embodiments of Intellectual Property. Physical property, such as books, records, computer disks, prototypes, artwork and computer code, are often necessary for to create or use intellectual property.

1. Software applications may be protected by several different forms of intellectual property rights.
 - a. Patents covering the software functionality.
 - b. Trade secret information contained in the structure of the program, algorithms and routines.
 - c. Copyrights in the software program object code and source code, documentation, user and training manuals, flow charts and diagrams.
 - d. Trademarks displayed on splash or log-in screens.
2. Software licensed from a third party may be provided to the licensee in object code form only.
 - a. Source code may be needed to repair bugs in the licensed software and create enhancements.
 - b. Source code may be held in escrow and made available for release upon the occurrence of certain events, including the licensor's bankruptcy or its failure to perform support and maintenance obligations.
 - c. The licensor should be obligated to update the source code held in escrow with new versions of the licensed software. In addition, the escrow deposit should include materials, such as documentation and flow charts to aid the licensee's understanding of how the source code is written.
 - d. The licensee will require a license to use the source code for the licensed software upon its release from escrow.

Exhibit II

Suggested 365(n) Rejection Procedures Language

Any non-debtor parties who elect to retain intellectual property rights under Section 365(n) of the Bankruptcy Code with respect to any contract designated as “Reject” on Exhibit “A” hereto must do so by no later than [ten-twenty days after service of the order] by serving a declaration under penalty of perjury on the [Debtor or Trustee] [and any purchaser of the IP assets] by facsimile or overnight mail identifying the license agreement and intellectual property allegedly encumbered by it, and setting forth with particularity the basis upon which such non-debtor party asserts a license in the intellectual property, as well as all supporting documentation. Any non-debtor party to a rejected executory contract who fails to deliver such a declaration by [the election bar date] shall automatically forfeit its ability to make an election to retain its intellectual property rights under Section 365(n) of the Bankruptcy Code with respect to such contract. If the [Debtor or Trustee] [and/or any purchaser] objects to an election to retain Section 365(n) rights, the [Debtor or Trustee] [and/or any purchaser] shall set a hearing on the objection on at least 10 days’ notice to the other party. The initial hearing shall be a status conference, at which the Court may set further hearings, as appropriate.