

Drafting the Intellectual Property License: Bankruptcy Considerations

WARREN E. AGIN*

The bankruptcy process¹ potentially affects any commercial deal. When one party has financial problems, the impact on the other party to a license can be very serious. A poorly drafted license agreement will contain pitfalls when a party goes bankrupt. A well-crafted license agreement will protect against unforeseen treatment of the license if a party files a bankruptcy petition.

1. The Concept of “Executory Contract”

Almost all license agreements will be “executory contracts” for bankruptcy purposes.² Most courts use the “Countryman definition” to determine whether a contract is executory.³ Under this standard, also described by some courts as the “material breach test,” an executory contract is:

. . . a contract under which the obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.⁴

Some courts use an alternative test, referred to as the “functional analysis

* Warren E. Agin is a member of Swiggart & Agin, LLC, in Boston, Massachusetts and author of *BANKRUPTCY AND SECURED LENDING IN CYBERSPACE* (Bowne & Co. 2000). Mr. Agin also chairs the American Bar Association’s Electronic Transactions in Bankruptcy Subcommittee.

¹ Referring to a filing under Title 11 of the United States Code.

² 11 U.S.C. § 365 governs treatment of executory contracts in bankruptcy cases. Andrew M. Kaufman, *Technology Transfers And Insolvency—Some Practical Considerations*, *COMPUTER LAWYER*, Vol. 10, No. 9 (September 1993). See *In re Qintex Entertainment, Inc.*, 950 F.2d 1492, 26 Collier Bankr. Cas. 2d (MB) 143, 21 U.S.P.Q.2d (BNA) 1775, Bankr. L. Rep. (CCH) ¶ 74396 (9th Cir. 1991).

³ William N. Norton, Jr., *NORTON BANKRUPTCY LAW AND PRACTICE 2D*, § 39:6 (1994).

⁴ Vern Countryman, *Executory Contracts in Bankruptcy, Part I*, 57 *MINN. L. REV.* 439 (1973).

approach,” to determine whether a particular contract is executory.⁵ The functional analysis approach is more flexible than the Countryman definition and looks to the nature of the parties, the goals of reorganization, and whether acceptance or rejection will benefit the bankruptcy estate.

Software licenses with ongoing payment obligations are executory because the software licensor and software user typically have continuing obligations under the license. For example, the licensor might agree to indemnify and defend the licensee from infringement claims.⁶ Other covenants found within technology related licenses that can make the license executory include payment obligations, indemnities and warranties, training and support obligations, and confidentiality provisions.⁷

2. Assuming and Assigning Licenses

What happens to a software license in a bankruptcy case? In bankruptcy, assuming the license is an executory contract, the debtor has a choice between keeping the license in effect, called “assuming” the license, and terminating or “rejecting” the license.⁸ To assume a license, the licensee must (i) cure, or provide adequate assurance that it will promptly cure, any default; (ii) compensate any third party for any pecuniary loss caused by a default; and (iii) provide adequate assurance of future performance.⁹ By “rejecting,” the license the debtor loses the license’s benefit, but leaves the other party with a pre-petition unsecured claim.¹⁰ When the debtor wants to sell its business, or believes its interest in the license has value, it may try to “assign” its interest in the license to a third party. Understanding how this process works when either the licensee or licensor files bankruptcy will help guide the initial drafting process.

The licensee’s bankruptcy

When a licensee files bankruptcy, the licensor’s primary concern is payment.

⁵ Norton, *supra* note 3, § 39:7; Kaufman, *supra* note 2, at Pg. 23.

⁶ In re Qintex Entertainment, Inc., 950 F.2d 1492, 1496, 26 Collier Bankr. Cas. 2d (MB) 143, 21 U.S.P.Q.2d (BNA) 1775, Bankr. L. Rep. (CCH) ¶ 74396 (9th Cir. 1991) (content license was executory because of an exclusivity provision and licensor’s obligation to indemnify and defend the licensee from infringement.)

⁷ Kaufman, *supra* note 2, Pgs. 21, 23.

⁸ 11 U.S.C. § 365 (a).

⁹ 11 U.S.C. § 365 (b)(1).

¹⁰ 11 U.S.C. § 365 (g)(1).

Making the license executory forces the licensee to “assume” the license if it wants to continue to use the licensed content. Since “assumption” requires that the licensee cure any monetary breach, the licensor is paid in full. The licensee’s alternative is “rejecting” the license and giving up the benefit of the license. The licensee must choose between foregoing the licensed rights or performing under the terms of the license.

In most cases, the licensee will delay any decision to assume or reject the license and continue to use the intellectual property without making continuing royalty or license payments to the licensor. In this situation the licensor has two options: attempt to force the licensee to assume or reject the license or allow the licensee to continue to use the intellectual property without payment in the hope that the licensee eventually will assume the license. If the contract can be categorized as a lease of personal property, the licensor can also demand that the licensee perform its obligations under the contract starting 60 days after it filed its bankruptcy petition.¹¹ The strategy used by the licensor should depend on the cost to the licensor of performing its continuing obligations under the license and the lost opportunity cost to the licensor. Frequently in the case of non-exclusive licenses these costs are nominal. For example, the licensor of software used to operate a website incurs its greatest expenses at the beginning of the relationship. Allowing the debtor to continue to use the software to operate the website during the course of the bankruptcy case costs the licensor very little. In such cases, the licensor should allow the licensee time to reorganize its affairs and make an informed decision whether to affirm or reject the license. In most cases, the licensee is less likely to assume the license if pressured to do so early in the case because it may lack the necessary resources to allow it to cure its defaults under the license and because it will need to conserve cash flow during the reorganization. The licensee will eventually assume any license sufficiently important to website operation and pay the licensor in full.

The licensor will want to force the licensee to make its decision early in four situations. First, where the licensor is incurring significant ongoing costs in connection with its obligations under the license agreement. This situation can occur where a licensor is under an obligation to continue to produce content for use by the licensee. Second, where more lucrative opportunities would be available to the licensor if the license were rejected. This situation occurs when a grant of an exclusive license to use content prevents the licensor from pursuing other licensees. Third, where the licensee’s financial problems prevent it from properly developing or exploit-

¹¹ 11 U.S.C. § 365(d)(10). This section will apply to equipment leases. Thus, in a transaction where hardware is transferred from the licensor to the licensee for the licensee’s use during the license term, the licensor may want to draft a separate lease agreement to govern the hardware transfer.

ing the licensed intellectual property. Fourth, where the licensee is expected to assume the license and then assign it to a third party to the disadvantage of the licensor. In these situations, the licensor may want to move the bankruptcy court to require the licensee to assume or reject the license earlier in the bankruptcy process.

In some cases, the licensor is also concerned with controlling the licensed technology. The debtor might want to transfer the license interest to a competitor or potential customer of the licensor. In bankruptcy, a licensee may “assign” a license interest in this manner although prohibited by the license terms,¹² but this right is not absolute.

Rather than define the specific instances when a license may not be assigned, the Bankruptcy Code restricts assignment when non-bankruptcy laws (but not contractual terms) excuse the non-debtor party to the contract from accepting performance from an assignee.¹³ Thus, the Code looks to other law, either statutory or judicial, to determine when forced assignment of contract rights should not be allowed.

This principle effects primarily a licensee’s interest in non-exclusive patent licenses, which courts have almost uniformly held is not assignable in a bankruptcy case absent the licensor’s express consent.¹⁴ The relevant applicable law is the Federal common law principle that non-exclusive patent licenses are personal in nature and contain an implied term restricting assignment.¹⁵ The principle may also apply to copyright licenses, which are

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Except as provided in subsection (c) of this section, notwithstanding a provision in an executory contract . . . of the debtor, or in applicable law, that prohibits, restricts or conditions the assignment of such contract . . . , the trustee may assign such contract . . . under paragraph (2) of this subsection. . . . 11 U.S.C. § 365 (f)(1).

Paragraph 2 of section 365 (f)(1) conditions assignment on the trustee first assuming the contract and on the assignee providing adequate assurance of future performance of the contract.

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The trustee may not assume or assign any executory contract . . . of the debtor, whether or not such contract . . . prohibits or restricts assignment of rights or delegation of duties, if applicable law excuses a party, other than the debtor, to such contract . . . from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract . . . prohibits or restricts assignment of rights or delegation of duties. . . . 11 U.S.C. § 365 (c)(1)(A).

¹⁴ *Everex Systems, Inc. v. Cadtrak Corp. (In re CFLC, Inc.)*, 89 F.3d 673, 679-80, 29 Bankr. Ct. Dec. (CRR) 520, 36 Collier Bankr. Cas. 2d (MB) 297, 39 U.S.P.Q.2d (BNA) 1518 (9th Cir. 1996) (Bankruptcy estate prohibited from assigning licensee’s interest in patent license.)

¹⁵ See, e.g., *C.I.R. v. Sunnen*, 333 U.S. 591, 609, 68 S. Ct. 715, 92 L. Ed. 898, 77 U.S.P.Q. (BNA) 29, 48-1 U.S. Tax Cas. (CCH) ¶ 9230, 36 A.F.T.R. (P-H) ¶ 611 (1948).

also considered personal in nature from an intellectual property perspective.¹⁶

Potentially, Bankruptcy Code section 365(c)(1) prevents not only assignment of patent and copyright license rights but mere assumption by a reorganizing debtor. The provision uses the language “the trustee may not assume or assign any executory contract. . . of the debtor...”¹⁷ Some courts have said the use of the word “or” means a patent licensee may not assume the patent license in a bankruptcy case.¹⁸ However, this position is not universal and a debtor might be able to indirectly assign a licensee’s interest in a patent license by selling its stock to a third party.¹⁹

The licensor’s bankruptcy

When a software licensor files bankruptcy, the licensee may have a problem, especially if the license agreement is not executory. The licensor can in that case breach the license agreement, either by failing to provide support or technology, or by re-licensing the subject matter of the license in contravention of the license terms. If the license is executory, the licensor might

¹⁶ Harris v. Emus Records Corp., 734 F.2d 1329, 222 U.S.P.Q. (BNA) 466 (9th Cir. 1984), (Bankrupt licensee of copyrights under recording contract prohibited from assigning rights under Bankruptcy Act.) In re Patient Educ. Media, Inc., 210 B.R. 237, 31 Bankr. Ct. Dec. (CRR) 49 (Bankr. S.D.N.Y. 1997) (Bankruptcy estate could not assume and assign copyright licensee’s right to use photographs in packaging material); see, Sony Corp. of America v. Universal City Studios, Inc., 464 U.S. 417, 429, 104 S. Ct. 774, 78 L. Ed. 2d 574, 220 U.S.P.Q. (BNA) 665 (1984).

¹⁷ 11 U.S.C. § 365 (c).

¹⁸ These courts have adopted what is called the “hypothetical test,” holding that the trustee may not assume the license if section 365 (c)(1)(A) would prohibit a hypothetical assignment of the license right. Cases adopting the hypothetical test in the context of patent licenses include In re Catapult Entertainment, Inc., 165 F.3d 747, 33 Bankr. Ct. Dec. (CRR) 1058, 41 Collier Bankr. Cas. 2d (MB) 858, Bankr. L. Rep. (CCH) ¶ 77886 (9th Cir. 1999), cert. dismissed, 120 S. Ct. 369, 145 L. Ed. 2d 248 (U.S. 1999) and In re Access Beyond Technologies, Inc., 237 B.R. 32, 34 Bankr. Ct. Dec. (CRR) 919 (Bankr. D. Del. 1999). Other courts adopting the hypothetical test include: In re James Cable Partners, L.P., 27 F.3d 534, 25 Bankr. Ct. Dec. (CRR) 1499, 31 Collier Bankr. Cas. 2d (MB) 1104 (11th Cir. 1994), Matter of West Electronics Inc., 852 F.2d 79, 18 Bankr. Ct. Dec. (CRR) 287, Bankr. L. Rep. (CCH) ¶ 72351, 34 Cont. Cas. Fed. (CCH) ¶ 75526 (3d Cir. 1988), and In re Catron, 158 B.R. 629 (E.D. Va. 1993), aff’d w/o opinion, 25 F.3d 1038 (4th Cir. 1994).

¹⁹ Some courts have adopted the “actual test” in interpreting section 365(c)(1)(A). The actual test holds that the trustee may assume the license unless the proposed transaction will result in the licensor being forced to do business with someone other than its original licensee. Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489, 30 Bankr. Ct. Dec. (CRR) 221, 37 Collier Bankr. Cas. 2d (MB) 588, 41 U.S.P.Q.2d (BNA) 1503, Bankr. L. Rep. (CCH) ¶ 77242 (1st Cir. 1997), following the Circuit’s earlier decision in Summit Inv. and Development Corp. v. Leroux, 69 F.3d 608, 28 Bankr. Ct. Dec. (CRR) 200, 34 Collier Bankr. Cas. 2d (MB) 1351, Bankr. L. Rep. (CCH) ¶ 76695 (1st Cir. 1995).

“reject” the license, ending the licensee’s rights to use the licensed technology. The licensee, perhaps deprived of an essential technology, will be left only with a damage claim against the licensor’s bankruptcy estate. The Bankruptcy Code provides technology licensees with some protection. Bankruptcy Code section 365(n) allows certain licensees to retain their rights in intellectual property despite the licensor rejecting the license agreement.²⁰

Section 365(n) only applies to executory contracts under which the debtor is a licensor of a right to “intellectual property.”²¹ The term “intellectual property” has a special meaning under the Bankruptcy Code and is limited to trade secrets, United States patents and patent applications, plant varieties, United States copyrights, and United States mask works.²² Section 365(n) does not provide protection for licenses for the use of a trademark, licenses of technology or content which are not protected by federal copyright or patent law,²³ or licenses for the use of some database compilations.²⁴

When a debtor rejects a technology license, the licensee has two options. First, the licensee can treat the contract as terminated.²⁵ The licensee then loses its ability to use the content provided under the license, but has a damage claim against the debtor, essentially the same treatment obtained upon breach of a regular executory contract.

Second, the licensee can elect to retain its rights under the license to the intellectual property as such rights existed immediately before the bankruptcy case.²⁶ In that case, the licensee can continue to use the licensed technology or information. A licensee electing to retain rights does not retain all of its rights as described in the license, but a specific bundle of rights provided by the bankruptcy code. These rights include the right to enforce any exclusivity provision of the license;²⁷ the right to the intellectual property as such rights existed immediately before the case commenced for the

²⁰ 11 U.S.C. § 365(n).

²¹ 11 U.S.C. § 365(n)(1).

²² 11 U.S.C. § 101(35A).

²³ 35 U.S.C. §§ 1, et. seq., 17 U.S.C. §§ 101, et. seq.

²⁴ *See*, Feist Publications, Inc. v. Rural Telephone Service Co., Inc., 499 U.S. 340, 111 S. Ct. 1282, 113 L. Ed. 2d 358, 18 Media L. Rep. (BNA) 1889, 18 U.S.P.Q.2d (BNA) 1275, 121 Pub. Util. Rep. 4th (PUR) 1 (1991).

²⁵ If the rejection by the trustee amounts to a breach that would allow the licensee to treat the contract as terminated by its own terms, applicable non-bankruptcy law, or an agreement between the licensee and another entity. 11 U.S.C. § 365(n)(1)(A).

²⁶ 11 U.S.C. § 365(n)(1)(B).

²⁷ *Id.*

duration of the contract;²⁸ and access to and protection of confidential information or rights under any supplementary agreement held in escrow by a third party.²⁹ The licensee will also have the right, if provided under the license or any supplementary agreement, to surrender of intellectual property related to the license.³⁰ In return for these rights, the licensee must make all royalty payments due under the license for the duration of the license³¹ and the licensee must waive its rights of setoff and all administrative claims against the bankruptcy estate arising from the performance of the license.³²

3. Drafting Techniques

Properly drafting the original license agreement can control treatment of the license in a bankruptcy case, or at least eliminate some of the danger presented when a party to the agreement files a bankruptcy petition.

Because Bankruptcy Code section 365(n) provides significant additional benefits to the intellectual property licensee, licensees should make sure the license explicitly references the statute. The statute requires certain key terms. The license should describe the intellectual property in terms that satisfy the Bankruptcy Code definition of intellectual property and state that the contract is subject to the provisions of section 365(n) when the licensor files a bankruptcy petition. To ensure courts treat the license as an executory contract, the license should state that the licensor's failure to perform continuing obligations constitutes a material breach of the contract excusing performance by the licensee.

The license should clearly provide that the licensor, in case of the licensor's bankruptcy, will on written request provide to the licensee any intellectual property and any embodiment of that intellectual property held by the licensor. The license should also describe the intellectual property and embodiments of intellectual property that must be turned over.

If the licensor rejects the license, the licensee may have to hire third-party vendors to perform support, maintenance, or development tasks previously performed by the licensor. The license should allow the licensee to provide intellectual property to such third parties without violating non-disclosure or exclusivity provisions.

²⁸ *Id.* The right to the intellectual property is retained for the duration of the license, plus any period for which the license may be extended by the licensee as of right under applicable nonbankruptcy law.

²⁹ *Survey: The Treatment of Intellectual Property Interests in Bankruptcy*, JOURNAL OF BANKRUPTCY LAW AND PRACTICE, at 437, n. 383.1, Vol. 4, No. 4 (May/June 1995).

³⁰ 11 U.S.C. § 365(n)(3)(A).

³¹ 11 U.S.C. § 365(n)(2)(B).

³² 11 U.S.C. § 365(n)(2)(C).

Section 365 requires a licensee that elects to continue to use intellectual property under a rejected license to continue to make royalty payments to the licensor. This obligation continues for the duration of the contract and any extension period available to the licensee.³³ The term “royalty payments” is defined broadly for bankruptcy purposes, regardless of the terminology used in the agreement to describe the payments.³⁴ The licensee can be forced to make all future payments under the license while the licensor eliminates continuing license obligations, such as continuing development obligations, maintenance and support obligations, obligations to provide updates, or obligations to defend against or prosecute infringement actions. The license should separate “royalty payments” made for the use of the intellectual property itself from the payments made for other services, in effect creating two executory contracts. Another option is to include a clause reducing royalty payments in case of non-performance of the licensor’s obligations. A license of trademark rights should include a provision reducing royalty payments if trademark license rights are terminated or lost. Any such provision included must be triggered by non-performance, not by a bankruptcy or insolvency case, because such “ipso facto” clauses are unenforceable under the bankruptcy code.³⁵

The license should clearly define the events the parties consider material breaches of the contract. This will help courts that employ the Countryman standard determine whether or not the contract is executory, or at what point the contract is no longer executory. In some cases, the licensor or licensee may want to draft around the executory nature of the contract so that 11 U.S.C. § 365 does not apply. This can be attempted by de-emphasizing the licensor’s continuing obligations.

A licensee can further protect itself by requiring technology escrows and drafting the license to allow recovery of the escrowed materials during a bankruptcy case. In a technology escrow, the parties entrust essential information and data, such as source code, with a trusted third party.³⁶

A licensor might protect itself against a licensee rejecting the license by including special early termination fees, or by including liquidated damage provisions accelerating payment of future royalties on termination. Such provisions may help increase the licensor’s unsecured claim and thus its recovery in a bankruptcy case.

³³ 11 U.S.C. § 365(n)(2)(B).

³⁴ *In re Prize Frize, Inc.*, 32 F.3d 426, 429, 25 Bankr. Ct. Dec. (CRR) 1615, 31 Collier Bankr. Cas. 2d (MB) 1422, 31 U.S.P.Q.2d (BNA) 1861, Bankr. L. Rep. (CCH) ¶ 76039 (9th Cir. 1994).

³⁵ 11 U.S.C. §§ 365(e)(1), 541(c)(1).

³⁶ Warren E. Agin, *BANKRUPTCY AND SECURED LENDING IN CYBERSPACE* (Bowne & Co. 2000) Chapter 11.

The licensor wants to guard against the licensee assigning its interest in the license to a third party. The Bankruptcy Code allows such assignment, notwithstanding assignment restrictions in the contract. The sole qualification is that the assignee must provide adequate assurance of future performance,³⁷ a term the Bankruptcy Code does not define.

License provisions can attempt to define what constitutes adequate assurance of future performance in case of an assignment to a third party, allowing the licensor more control over the assignment process. For example, the assignee may be required to affirmatively assume the assignor's obligations under the license or the license may define certain required net worth or capital requirements for assignees. To eliminate the risk that a license is assigned to the licensor's competitor, the original parties should incorporate non-compete clauses into the license. To eliminate the risk that the assignment conflicts with exclusive licensing arrangements with third parties, the license should clearly describe the scope of the license granted. To reduce the risk that the assignee of a development license or VAR license lacks the skill or resources necessary to generate value for the licensor, the license should include benchmarks, financial or otherwise, which must be met by the licensee. Such provisions should be carefully drafted to apply to the original licensee, not just assignees, because the Bankruptcy Code recognizes neither provisions that prohibit, restrict or condition assignment,³⁸ nor provisions that terminate or modify a license on account of assignment.³⁹

To address case law prohibiting assumption of patent licenses, the licensee will want the license to allow assumption or retention of the license in a bankruptcy proceeding, even when the license prohibits or restricts assignment. The licensor might limit a "consent to assumption" provision to situations that do not involve a change of control over the licensee.

Both licensees and licensors can protect against bankruptcy filings by obtaining security interests in the licensed intellectual property, and other related assets. This technique is not widely used, but can provide substantial protection for both the licensor and licensee in various situations. For the licensor, retaining a security interest in embodiments of intellectual property held by the licensee assists the licensor in recovering the intellectual property in case of a bankruptcy. For the licensee, obtaining a security interest against intellectual property held by the licensor will assist it in recovering additional materials necessary to use the intellectual property retained. For example, a VAR that uses technology under license and licenses the right to use patent holder's trademark may want to obtain a security interest in the

³⁷ 11 U.S.C. § 365(f).

³⁸ 11 U.S.C. § 365(f)(1).

³⁹ 11 U.S.C. § 365(f)(3).

trademarks. This technique complements the protections provided by section 365(n), which do not extend to trademark licenses. For both licensees and licensors, obtaining a security interest in assets will turn a general unsecured claim against the bankruptcy estate into a secured claim, improving any monetary recovery on the claim.⁴⁰

⁴⁰ 11 U.S.C. § 506(a).