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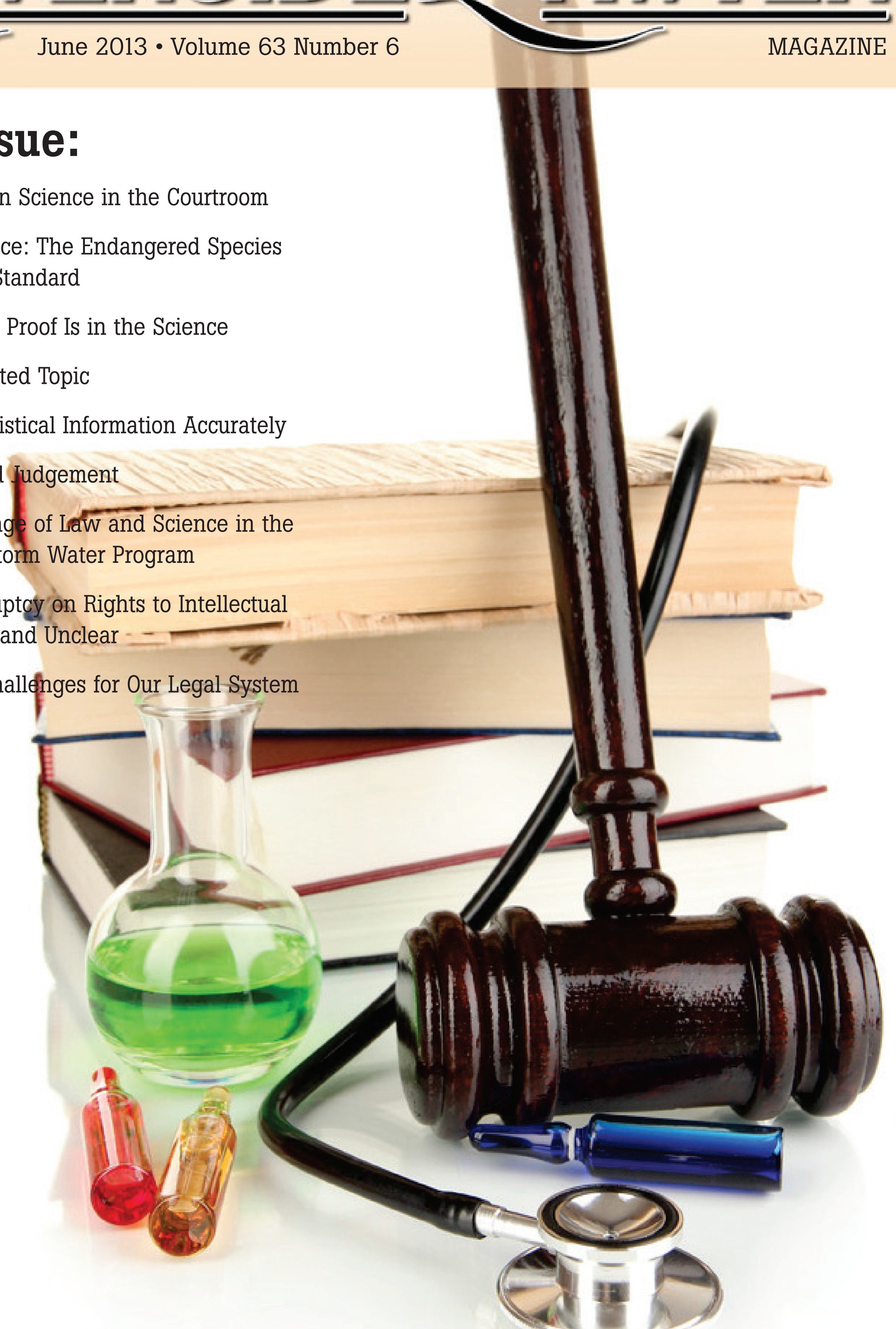

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The Effect of Bankruptcy on Rights to Intellectual Property: Important and Unclear

by Mary D. Lane

Previously, only "creative" businesses had to be concerned about intellectual property. They owned rights to literary works, films, television, music, or designs or had been granted rights to use or market such material. Usually, transfers occurred by way of "licenses" for certain territories, time frames, and uses. Law firms either specialized in transactions involving intellectual property or didn't touch the subject.

As computers became ubiquitous and technology proliferated, most companies began to obtain licenses to use material that is or could be the subject of a patent, copyright, or trade secret. Small businesses in fields not commonly considered creative began to acquire rights to use special-purpose computer systems or other state-of-the-art technology. Other companies created technology and contracted with businesses that wanted to use the technology for certain purposes, places, and times. And many, if not most, businesses developed trademarks that helped in branding their products.

Perhaps as a function of the rapid change in technology or the all-pervasive nature of technology, today, more substantial companies entering Chapter 11 exit after having conducted a section 363[1] sale of substantially all their assets, undertaken at an early stage in the case.[2] The seller and potential buyers must understand what rights the debtor has, what it can transfer, and what cure, if any, will need to be made.

Even lawyers working with companies with hard assets like machinery must have a basic understanding of what can happen to intellectual property in bankruptcy. Transactional lawyers should insert appropriate, and enforceable, provisions in contracts and licenses. Bankruptcy lawyers must be familiar with the Bankruptcy Code provisions relating to intellectual property, if only to know when to seek advice from a specialist.

Assumption or Rejection of Executory Contracts in Conjunction with a Section 363 Sale

Generally, the Bankruptcy Code allows a debtor to assume or reject an "executory contract," which is a contract under which some material performance remains to be undertaken by both parties.[3] A debtor's decision to assume or reject is approved by the bankruptcy court under the lenient "business judgment" standard.[4]

In a section 363 sale, the debtor moves the court for approval of the sale procedures. Any stalking-horse purchaser will have decided which of the important contracts it wants to assume, and its purchase will be conditioned on successfully assuming those contracts. The procedures will allow, or disallow, potential overbidders to change which contracts are to be assumed. But even if changes are allowed, potential overbidders who were not deeply involved with the debtor pre-petition do not have time to review the contracts.

Assumption

Assumption is straightforward. The debtor may assume, subject to limited exceptions,[5] if it (1) cures or gives adequate assurance that it will promptly cure any defaults, (2) compensates or gives adequate assurance that it will promptly compensate the counterparty for any actual pecuniary loss resulting from the default, and (3) provides adequate assurance of future performance.[6] Concurrently with assuming a contract, a debtor may assign its rights in a contract to a third party, if that third party provides adequate assurance of future performance.

Although most contracts still contain language that the commencement of a bankruptcy case constitutes a default, such "ipso facto" clauses are not enforceable. Even when a debtor must cure a default in order to assume or assume and assign a contract, it is *not* required to cure a default occasioned by the filing of the bankruptcy case or the state of the debtor's finances as of the filing of the case.[7] Were it other-

1 Unless otherwise noted, all statutory references are to the Bankruptcy Code, Title 11, United States Code.

2 See generally *Section 363 Sales: Mooting Due Process* (Dec. 2012) 29 Emory Bankr. Dev. J. 91.

3 Section 365(a). Whether a contract is executory is a question beyond the scope of this article.

4 See, e.g., *In re Orion Pictures Corp.* (2d Cir. 1993) 4 F.3d 1095, 1099.

5 A debtor cannot assume or assign a contract when applicable nonbankruptcy law allows the counterparty to refuse performance from a third party, but most contractual obligations are not typically the kind of personal services obligation that cannot be assumed and assigned. An exception would be a contract that calls for a performance by, for example, Billy Joel; if Billy Joel was in bankruptcy, he could not assume the contract and assign it to, for example, Billy Idol, unless, of course, the counterparty agreed to the substitution.

6 Section 365(b)(1).

7 Section 365(b)(2).

wise, the impossibility of curing ipso facto defaults would nullify the debtor's right to assume under the Bankruptcy Code. (Transactional lawyers routinely put such clauses in contracts. This is harmless, so long as their clients aren't fooled into believing they are enforceable.)

Rejection

If the debtor rejects a contract, the counterparty gets a prepetition unsecured claim for rejection damages that is payable at as many cents on the dollar, if any, as allowed unsecured claims.[8] That, in itself, is usually an undesirable result for the counterparty.

What happens to the rights that the counterparty had under the contract? Often recipients of contract rights have invested substantial sums in reliance on their contracts and are concerned that their rights will vaporize, as happened in the shocking 1985 *Lubrizol* decision.[9] In *Lubrizol*, the Fourth Circuit allowed a debtor licensor to reject a fully paid-up technology license so that it could sell or license the technology to another party for one reason alone – more money. The court ruled that the license vaporized; the licensee could no longer use the technology; and all the licensee had was an unsecured claim for damages, payable at the unsecured claims percentage.

Most everyone found the *Lubrizol* decision appalling for many reasons, especially because the license had been fully paid-up and arguably the transaction was in substance a completed sale documented in the parlance of a license. Reacting to the outrage, in 1988, Congress enacted section 365(n), which provides that, upon rejection of a license of "intellectual property," the licensee has the option of (1) treating the contract as terminated or (2) retaining its rights by continuing to make royalty payments without exercising any right of setoff or recoupment.

Unfortunately, the definition of "intellectual property," which includes patents, copyrights, and trade secrets, does not include trademarks.[10] Some courts have found some equitable basis to treat trademarks like other intellectual property, but most courts have followed the literal language. Whatever Congress was thinking, the result has been that recipients of rights to patents *and* trademarks or copyrights *and* trademarks have faced different treatment of their patents or copyrights under section 365(n) than of their trademark rights.

In 2012, the Seventh Circuit held in *Sunbeam*[11] that the licensee of patents and trademarks could keep both the patents *and the trademarks*. It concluded that the Fourth Circuit had wrongly decided *Lubrizol* and the *Lubrizol* licensee should have been able to keep the licenses. Reasoning from nonbankruptcy law, not from section 365(n), it concluded that, when a licensor breaches its contract, the licensee has the option of treating the breach as ending its own obligations under the license or continuing to sell the product under the license. In other words, rejection does not vaporize the contract, but rather it merely frees the estate from the obligation to perform further affirmative acts.

Of course, *Sunbeam* in itself raises a number of issues. If a licensee can continue to sell the product based on general rules of rejection rather than section 365(n), why would it choose to make the election to retain its license under section 365(n), which requires that licensees pay royalties without setoff? It seems that if a licensee does not make the section 365(n) election in a *Sunbeam* jurisdiction, it can still keep the rights under the general rules of rejection (rendering section 365(n) superfluous). In December 2012, the Supreme Court declined to resolve the conflict between the Fourth Circuit's *Lubrizol* decision, which controls at least in the Fourth Circuit as to trademarks, and the Seventh Circuit's *Sunbeam* decision. Only time will tell which other circuits agree with *Sunbeam*.

The Ninth Circuit has not addressed the issue. A Northern California bankruptcy court,[12] whose decision is not binding even on other California courts, concluded that licensees are not entitled under 365(n) to retain trademarks, and the licensee's remedy is to vigorously contest rejection of the license, *before* rejection occurs, on the grounds that all the licensor can be is a spoiler: if the licensee gets to retain the patent, copyright, and trade secrets associated with the same product, what use are the trademark rights to the licensor? However, under the business judgment standard, the debtor's decision is upheld unless there is no justification whatsoever for the proposal. This conundrum is ripe for negotiation, under which the spoiler licensor gets paid for agreeing to assign the trademark rights to the licensee (who already had them) and the licensee, seething at paying twice for the same rights, reluctantly agrees that some payment is better than outright loss of the trademark license.

Conclusion

Although assumption of "intellectual property" rights is often straightforward, rejection creates minefields through which a counterparty must pick its way, preferably with the assistance of bankruptcy counsel knowledgeable in the area.

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8 Section 365(g)(1).

9 *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.)* (4th Cir. 1985) 756 F.2d 1043.

10 Section 101(35A).

11 *Sunbeam Products, Inc. v. Chicago American Mfg.*, 686 F.3d 372 (7th Cir. 2012), cert. denied ___ U.S. ___ [133 S.Ct. 790].

12 *Rai-Ma UK Ltd. v. Centura Software Corp. (In re Centura Software Corp.)* (Bankr. N.D. Cal. 2002) 281 B.R. 660, 668.