



Intellectually Bankrupt?

Five pitfalls to avoid when it comes to the treatment of intellectual property interests in bankruptcy proceedings.

If you spend any amount of time with a group of bankruptcy lawyers, not only might you develop a somewhat skewed perspective of the world, but sooner or later someone will announce that bankruptcy lawyers are among the last “true generalists” in private practice. By this statement, they mean that bankruptcy lawyers, especially those that routinely represent companies in bankruptcy reorganization cases, need to know a lot about bankruptcy law and at least something about numerous other areas of the law.

In short, a bankruptcy lawyer needs to know enough about areas outside her chosen field to appreciate when to pick up the telephone and call one of her colleagues for assistance on a particular matter within a larger bankruptcy case.

The converse proposition, however, also holds true. Those that practice in other areas of the law, even ones seemingly remote from the bankruptcy world, need to know enough about what some might perceive as the arcane field of bankruptcy law to appreciate how the

bankruptcy overlay may affect their clients’ rights and obligations.

Ask pretty much any bankruptcy lawyer, and she is apt to launch into an account about how her corporate litigation, tax, insurance or [insert practice area name] colleagues got themselves into a boatload of trouble that could have been avoided had they just picked up the telephone and sought her advice at the first hint that the client or the other party might be experiencing some financial distress.

Perhaps nowhere does this scenario

play out more prominently than in the troublesome region where intellectual property law and bankruptcy law intersect. Pitfalls abound in the Bankruptcy Code for the unwary. The bulletproof intellectual property license that you thought you had negotiated is vitiated by the operation of certain provisions of the Bankruptcy Code after your licensee files for bankruptcy — or is it? The “bet the company” patent infringement litigation that was about to go to trial against the defendant which just filed for bankruptcy and its non-debtor subsidiary is enjoined by the automatic stay — or is it? Your right to continue using the trademark you licensed from your franchisor that just filed for bankruptcy is protected by the Bankruptcy Code — or is it?

These are but a few occasions of interactions between intellectual property law and the Bankruptcy Code that tend to produce results that one might not be able to intuit without developing some eye for how the Bankruptcy Code treats intellectual property interests.

The starting point for understanding the interplay between intellectual property and bankruptcy law is to realize that these two fields attempt to further some very different and often conflicting interests. For instance, one of the principal goals of patent law is to promote invention by recognizing and protecting property interests in technological developments, which is accomplished, in part, by allowing patentees to exclude others from making use of their proprietary technology.

The principal goals of the Bankruptcy Code include promoting reorganization and maximizing value for creditors, which are accomplished, in part, by removing restrictions that impede the free transferability of property. It is largely as a result of the Bankruptcy Code’s attempts to reconcile these potentially conflicting policy goals that many of the pitfalls involving the treatment of intellectual property in a bankruptcy setting arise.

While a comprehensive cataloguing

of every possible interaction between fields of intellectual property and bankruptcy law is beyond the scope of this modest article, I will attempt to identify some of those issues that have proven time and again to be the most irksome.

Pitfall #1: *Not understanding the rather peculiar way the Bankruptcy Code determines which intellectual property licenses can and cannot be assumed, or assumed and assigned, by a debtor or trustee.*

Consistent with the Bankruptcy Code’s overall policy goals of promoting reorganizations and maximizing value, it generally favors the free assignability of prepetition contracts, and section 365 of the Bankruptcy Code gives a trustee or debtor the authority to assume, or assume and assign, most executory contracts.

The Bankruptcy Code, however, also attempts to do as little violence as possible to applicable non-bankruptcy law by recognizing that in several areas the assignment of contracts should be prohibited or restricted. The result of these efforts is reflected in sections 365(c) and 365(f) of the Bankruptcy Code, two seemingly contradictory provisions that have befuddled and continue to befuddle litigants and courts. *See* 11 U.S.C. § 365(c) & (f).

The application of these provisions to intellectual property licenses has proven particularly challenging. The threshold inquiry is whether the agreement really is an executory contract (*i.e.*, a contract on which performance remains due to some extent on both sides), or something else, such as a sale.

Frequently, although not always, courts make this distinction on the basis of whether the license is non-exclusive (*i.e.*, merely grants the licensee permission to use certain intellectual property) or exclusive (*i.e.*, transfers to the licensee (and divests the licensor of) some significant portion of the ownership rights associated with the intellectual property).

If the license agreement is determined to be executory, then the question under section 365(c) is whether “applica-

ble law” would excuse the non-debtor party from accepting performance from or rendering performance to a party other than the debtor. The term “applicable law” in the context of intellectual property licenses generally refers to patent law, copyright law or trademark law. As a general proposition, patent law and copyright law have been held to make non-exclusive licenses nonassignable without the consent of the licensor.

In contrast, the rights of a trademark holder to control the use of its mark may be more limited, which creates more uncertainty about whether section 365(c) would necessarily excuse a trademark holder from accepting performance from or rendering performance to a party other than the debtor per the license’s terms.

Another peculiar aspect of the way the Bankruptcy Code treats licenses of intellectual property to debtors is in the manner in which sections 365(c) and 365(f) are applied to affect the ability of a debtor in possession (*i.e.*, a debtor in a chapter 11 reorganization case in which no separate trustee has been appointed) to assume a license even when assignment is not contemplated (*i.e.*, where the debtor seeks only to exit bankruptcy with the rights and obligations under the license intact, but not to transfer it to a third party). In this situation, whether or not the debtor will be stripped of the opportunity to assume a license without the non-debtor party’s consent may depend on the venue in which the debtor’s bankruptcy case was commenced.

Several circuits, including the Third Circuit, follow the so-called “hypothetical” approach, which they conclude is mandated by the specific language of section 365, and do not permit a debtor’s assumption of a license if “applicable law” would not allow its assignment to a third party. Other circuits follow the so-called “actual” approach (or variants thereof), pursuant to which they reject the notion that the debtor in possession should be presumed to be an entity distinct from the pre-petition debtor and typically allow assumption to occur,

even when applicable law would restrict assignment to a third party.

Thus, although all courts are interpreting the same language, there is no broad consensus among federal courts about the manner in which these provisions are to be applied.

Furthermore, even the few broad generalizations that can be made about the treatment of intellectual property licensed to a debtor can break down when applied to the facts of a given case. In most instances, it will be necessary to examine the nature of the intellectual property rights at issue and the terms of the license before any reliable conclusion can be reached about the license's transferability without the express consent of the licensor.

As a practical matter, this means that care must be taken by intellectual property holders long before the advent of the bankruptcy to structure a license in such a way to maximize the likelihood that its restrictions on assignability will be enforced within a bankruptcy proceeding.

Pitfall #2: *Being unfamiliar with the reach of the automatic stay that comes into effect when a debtor files a bankruptcy petition.*

Pursuant to section 362(a), upon the filing of a bankruptcy petition, an injunction automatically comes into effect against certain actions, including

- (1) the commencement or continuation . . . of [an] action or proceeding against the debtor that was or could have been commenced before the commencement of the [bankruptcy] case . . . , or to recover a claim against the debtor that arose before the commencement of the [bankruptcy] case . . . ;
- (2) the enforcement, against the debtor or property of the estate, of a judgment obtained before the commencement of the [bankruptcy] case . . . ;
- (3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;
- [and] (6) any act to collect, assess, or recover a claim against the debtor

that arose before the commencement of the [bankruptcy] case

11 U.S.C. § 362(a).

Exactly what this language means for participants in intellectual property litigation is not always clear. The stakes, however, if one is wrong about whether the automatic stay applies may be significant, because actions taken in violation of the automatic stay may be deemed void or voidable and, if done willfully, may result in the imposition of actual and punitive damages. *See* 11 U.S.C. § 362(h).

Even in a simple, bilateral patent infringement suit the question of whether the automatic stay applies is not always clear. For instance, it is not unusual for an accused infringer to file a preceptive suit seeking a declaration of non-infringement and for the defendant in such a suit to counterclaim for damages and injunctive relief. When the plaintiff/counterclaim-defendant in such an action then files for bankruptcy, it can create doubt as to whether and to what extent the automatic stay applies.

Certainly, in such a situation the infringement count brought by the defendant/counterclaim-plaintiff would be stayed, but the impact of the automatic stay on the plaintiff/counterclaim-defendant's request for a declaration of non-infringement is less certain. Generally, actions *by* a debtor are not affected by the automatic stay, but when the nature of that action is essentially a request to determine the nonexistence of a claim against the debtor, there is greater likelihood that the action would not be permitted to proceed, either as a direct application of the automatic stay or for prudential reasons.

The impact of the automatic stay also can be uncertain in situations where elements of the action relate to events that have occurred after the debtor filed a bankruptcy petition. For instance, when a patent has issued *after* a debtor sought bankruptcy petition, it has been held that an action for damages and injunctive relief may be prosecuted against a debtor without first obtaining relief

from the automatic stay; however, the execution or attachment of a judgment obtained against a debtor through such an action would be barred, absent relief from the automatic stay.

Further, it has been suggested (on the theory that each act of infringement is an independent tort) that an action may be pursued against a debtor based upon its postpetition infringement even though the infringing acts commenced on a date prior to the bankruptcy filing; however, such an action also could be viewed as one that "could have been commenced before the commencement of the [bankruptcy] case . . ." and, therefore, violative of the stay.

Even more uncertainty creeps in when the question is presented of what effect a debtor-defendant's bankruptcy filing should have on the continuation of infringement litigation against parties who have not themselves sought bankruptcy protection, especially when those parties are closely connected with the debtor. As a general rule, litigation should proceed against non-debtor parties, but courts have found that the automatic stay can be extended to non-debtor defendants (or have otherwise granted injunctive relief) in situations where there exists a substantial identity of interests between the debtor and non-debtor parties, such that a judgment of infringement against the non-filing defendant might operate (either technically or practically) as a judgment against the debtor.

This is but a sampling of the types of issues that arise in the litigation context when an automatic stay comes into effect. There are numerous other permutations on these themes. The lesson to take away from this abbreviated discussion is to stop and fully consider all of the potential implications of the automatic stay when a bankruptcy filing occurs or is contemplated.

Pitfall #3: *Not appreciating the limited and incomplete nature of the Bankruptcy Code protections available to a debtor's licensees and sublicensees of intellectual property.*

When originally enacted, section 365 of the Bankruptcy Code allowed a debtor licensor to reject (*i.e.*, breach and cease performing under) an intellectual property license without regard to the potentially disastrous effects of such action on the viability of the business of its non-debtor licensee. Because of the perceived inequity of this result, in 1988, Congress added subsection 365(n) of the Bankruptcy Code in an attempt to provide special protections for non-debtor licensees.

Subsection (n) attempts to mitigate the effects of a debtor licensor's rejection of an intellectual property license by giving the non-debtor licensee the option to either (a) treat the license as terminated or (b) retain its rights to the licensed intellectual property under the license, other than the right to specific performance of any license provision (save for any exclusivity requirement). If the licensee opts to retain the right to use the intellectual property it must make all royalty payments under the license and may not assert against the debtor any setoff rights or administrative claims arising under the license.

Despite this legislative attempt to improve the lot of non-debtor licensees, it would be a mistake to assume that section 365(n) fully insulates them from the adverse consequences of a debtor's rejection. Section 365(n) has significant limitations that make its protections incomplete and may lessen the utility of those protections when available.

A notable limitation is that trademarks fall outside of the Bankruptcy Code's definition of "intellectual property," thereby placing trademark licenses beyond the reach of section 365(n). Thus, for example, the non-debtor franchisee of a debtor franchisor may find itself with no protection against the debtor franchisor's decision to reject its franchise agreement and thereby deny it the right to continue to use the trade name and trade dress.

Another limitation of section 365(n) is its potential inapplicability to sublicensees (as distinguished from licensees). Although there is no definitive guidance available concerning whether section 365(n)'s protections reach sublicensees of intellectual property, an analogous provision that allows a non-debtor tenant to remain in possession of premises after the debtor lessor has rejected its lease has been held not to extend such a right to a sublessee when the debtor is the tenant on a prime lease which is rejected. *See* 11 U.S.C. § 365(h).

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This result suggests that the rights of a sublicensee against the ultimate licensor may be governed exclusively by applicable non-bankruptcy law even when the bankruptcy act of the debtor sublicensor's rejection of the sublicense is the triggering event. If (as is often the case) under applicable non-bankruptcy law the total breach of the prime license would extinguish the sublicensee's right to use the technology, section 365(n) may be of no help to a sublicensee. To take a real world example, sublicensees of a software distributor that files for bankruptcy may well be without any protection under section 365(n) if that software distributor rejects its distribution agreement with the original licensor.

Finally, even when section 365(n) is available, its conditions may not be economically or otherwise viable for non-debtor licensees. Aside from the right to enforce the exclusivity provisions of the license agreement, all that the licensee retains is the bare right to practice the licensed technology subject to the terms of the license. Significantly, there is no ability to obtain specific performance of the licensor's other obligations under the license agreement, such as those related to training and support of the licensed technology. Furthermore, any rights under the license that the licensee might otherwise have had to alterations and improvements to the technology will be no longer recognized.

In short, section 365(n) provides little more than a basic safety net against catastrophic business failure resulting directly from the loss of ability to practice a licensed technology.

Pitfall #4: *Forgetting that bankruptcy cases often operate under the "scream or die" principle.*

The phrase "scream or die" harkens back at least 165 years, as indicated by this early usage in American literature:

But anything was better than this agony! Anything was more tolerable than this derision! I could bear those hypocritical smiles no longer! **I felt that I must scream or die** – and now – again – hark! louder! louder! louder! LOUDER!
— Edgar Allan Poe, *The Tell-Tale Heart* (1843) (emphasis added).

In reality, the term "scream or die" as used in the bankruptcy context probably owes less to great literature than it does to the bankruptcy bar's penchant for developing its own colorful lexicon. This phrase describes the concept that an interested party must file an objection by a stated deadline or forever forego the opportunity of challenging what the debtor or trustee proposes to accomplish by the noticed transaction. Thus, a holder of intellectual property

that fails to timely object to a bankruptcy transaction involving its property may be precluded from later challenging the transaction by any other means.

Failure to heed the “scream or die” rule can be particularly problematic for intellectual property holders. As a licensor of intellectual property to a debtor, you may be secure in the notion that the license agreement you drafted is immune from being treated as anything other than the personal, non-exclusive and nontransferable license that your client intended it to be.

Likewise, as a patent or copyright licensee of a debtor, you may be equally confident that your basic rights to continue using the licensed technology are protected pursuant to section 365(n) of the Bankruptcy Code even if the debtor attempts to reject your license.

If, however, in either case your assuredness about your position caused you to fail to object to a debtor’s attempt to sell the intellectual property free and clear of interests pursuant to section 363(f) of the Bankruptcy Code, you may find that your rights have been adversely affected.

Section 363(f) authorizes the sale of property “free and clear of any interest in such property of an entity other than the estate” in various situations, including when “such entity consents” or “such interest is in bona fide dispute.” 11 U.S.C. §§ 363(f)(2) & (4). Pursuant to these provisions, a party that claims an interest in intellectual property — possibly even when the claimed interest is the ownership of the intellectual property — may be at risk of having that interest severed from the intellectual property if the party is put on notice of the debtor or trustee’s adverse claim of ownership and intent to sell the intellectual property, but “consents” by failing to interpose a timely objection.

This is particularly so, where the debtor or trustee has made a record that ownership of such intellectual property is in *bona fide* dispute, such as the existence of unresolved litigation over the nature or extent of the asserted interest

in the intellectual property. A timely objection to a transaction involving one’s intellectual property should resolve any question of “deemed consent” and may go some distance to creating an opportunity for an intellectual property holder to protect its rights, even where ownership of intellectual property is contested by a debtor or trustee.

As for section 365(n)’s protections of licensees from a debtor, while the right to continue using intellectual property pursuant to the terms of the license might seem guaranteed by the express language of the statute, bankruptcy case law has cast doubt on this assumption. At least one Court of Appeals has held, in interpreting an analogous provision of the Bankruptcy Code, that the rights included for contract parties in that provision are not meaningfully different than any other “interest” that a debtor or trustee may sell free and clear of. Once again, however, a timely objection may be the predicate act that prevents a licensee from being stripped of its rights without receiving anything of value.

Pitfall #5: *Assuming that you will have more than a nanosecond to respond to protect your intellectual property interests in a bankruptcy case.*

Bankruptcy, by its nature, often requires quick action to monetize assets that are deteriorating in value. Businesses in many industries, especially technology driven firms that are dependent upon human capital, often do not fare well in bankruptcy. Key employees leave. Customer relationships sour.

This “melting ice cube” phenomenon means that a company may file for bankruptcy and immediately move for the authority to sell substantially all of its assets through an auction and sale process that could be completed on less than 30 to 45 days notice to creditors and other affected parties. The notice period provided to contract parties, such as those who may have licensed intellectual property to the debtor, is often significantly more compressed. The winning bidder for a debtor’s assets may not be identified until after the conclusion of an auc-

tion that occurs only well into the sale process. That winning bidder then may have the opportunity to designate which contracts and which assets it wants to take as part of the transaction.

By the time formal notice is given (if it is given) of the intent to transfer certain assets and contracts to the winning bidder, holders of intellectual property interests may be left with no more than a few days to evaluate the bona fides of the potential acquirer and the terms of the proposed transaction, and to act on that information to protect their rights.

While in some cases scenarios like the one above may be contrived to diminish the ability of contract parties to take action to block or increase the cost of a transaction, often it is the unavoidable consequence of attempting to monetize assets in a distressed environment. There is not much for intellectual property holders to do, except to heed warnings like this one to be vigilant about what happens in bankruptcy cases and to be proactive about asserting their rights.

Holders of intellectual property interests need to be aware of the ways the Bankruptcy Code protects — and sometimes fails to protect — their rights. An inherent level of uncertainty necessarily arises from the Bankruptcy Code’s imperfect attempt to harmonize the sometimes conflicting goals of intellectual property and bankruptcy law.

Careful planning for the advent of a bankruptcy and vigilance concerning what may transpire in a bankruptcy case are the twin keys to mitigating such risks and to maximizing the likelihood that intellectual property interests will be recognized and respected in a bankruptcy scenario. ♦

FOOTNOTE

1. The author would like to thank his co-participants on the “Intersection of Bankruptcy and Intellectual Property” panel co-sponsored by the United States Bankruptcy Court for the District of Delaware and the Delaware Chapter of the Federal Bar Association on September 11, 2008, to whom the author is gratefully indebted for their insightful comments that helped inspire this article.