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## **Intellectual Property in Bankruptcy**

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# Intellectual Property and Bankruptcy

# Worlds Collide, But It's Not As Bad As You Think It Is

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- Most common types
  - Chapters 7, 11 and 13
- Chapter 15 – Recognition of foreign proceedings
- Most IP issues arise in Chapter 11 where debtor is licensor or licensee of IP

- Not all IP is created equal
- Section 101(35A) defines “intellectual property” as the following
  - A trade secret
  - An invention, process, design, or plant protected under title 35
  - A patent application
  - A plant variety
  - A work of authorship protected under Title 17
  - A mask work protected under Chapter 9 of Title 17
- Note that this definition **does not** include trademarks, trade names or service marks
  - Licensees of trademarks, trade names and service marks are at risk if licensor files bankruptcy

- What happens to an IP license agreement if the owner of the intellectual property files a bankruptcy petition
- Is a license agreement an “executory contract”
  - Contract that requires some future or ongoing performance by both parties, where the outstanding obligations for the parties are material
  - Countryman test
- Examples of material obligations for executory purposes
  - The obligation of the intellectual property owner to refrain from suing the licensee
  - The obligation of the licensee to account for and pay royalties to the licensor
  - The duty to maintain confidentiality on the part of the licensee
  - The duty on the part of the licensor to indemnify and defend the licensee from infringement claims
- Nonexclusive license agreements – typically considered executory
- Exclusive license agreements – tantamount to sale and non-executory
- Cannot terminate an executory contract during bankruptcy

- Section 365 permits
  - Rejection
  - Assumption
  - Assumption and assignment
- Assumption requires the debtor to
  - Cure, or provide adequate assurance that it will promptly cure, defaults (subject to certain exceptions not pertinent to this discussion) under the contract
  - Compensate, or provide adequate assurance that it will promptly compensate, the other party to the contract for any actual pecuniary losses resulting from prior defaults
  - Provide adequate assurance of the debtor's ability to fully perform all of its future obligations under the contract
- Assignment requires the assignee to provide adequate assurance of its ability to perform all future obligations under the contract

# What Happens When a Licensor Rejects an IP License Agreement?

- Section 365(n) provides that if a debtor rejects an executory contract under which the debtor is a licensor of IP, the licensee may either
  - Elect to treat the contract as terminated (*i.e.*, breached), and file a proof of claim for damages flowing from the debtor's termination of the contract
  - Retain its rights to use the IP under the contract for the duration of the contract and for any extension periods provided for by the contract
- If non-debtor licensee elects to retain its rights to the IP
  - The licensee must continue to make all royalty payments due under the original term of the contract, and any term extensions that the licensee elects to exercise
  - The licensor must, upon written request, comply with contractual requirement to provide the IP to the licensee and must refrain from interfering with the rights of the licensee to the IP
- Hints for licensee
  - Be proactive
  - Do not wait for rejection to exercise Section 365(n) rights

# Are Any Protections Given to Trademark Licensees?

- Previously, some courts held that Sections 101(35A) and 365(n) created the inference that Congress did not intend to protect a trademark licensee in the same way in which an IP licensee is protected
- Other courts rejected this “negative inference” and held that bankruptcy courts have the authority to permit a non-debtor to retain a trademark license based upon the equities of the case
- The Seventh Circuit rejected the “negative inference” and relied on Section 365(g) to allow the licensee to continue to use the trademark
- On May 20, 2019, the Supreme Court issued its opinion in *Mission Product Holdings, Inc. v. Tempnology, LLC*
  - Victory for trademark licensees
  - Court rejected the “negative inference” and sided with Seventh Circuit’s holding that rejection of an executory contract simply constitutes a prepetition breach of that contract and does not act as either a contract rescission or a termination
  - Justice Sotomayor opened the door to Congress to tailor post-rejection provisions for trademark licensees



# What Happens When a Licensee Seeks to Assume an IP License Agreement?

- Contract cannot prohibit its own assignment
- Section 365(c)(1) provides an exception
  - A debtor “may not assume or assign” an executory contract or unexpired lease if “**applicable law** excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor” and “such party does not consent to such assumption or assignment”
  - “Applicable law” includes patent laws
  - A nonexclusive IP license is personal and not assignable without patent owner’s consent
- Implications of Section 365(c)(1) vary by Circuit and test employed
- Actual test: Licensors cannot prevent assumption unless the debtor-licensee intends to assume and assign
  - Adopted by First and Fifth Circuits and lower courts in Seventh, Eighth and Tenth Circuits

# What Happens When a Licensee Seeks to Assume an IP License Agreement? (cont.)

- Hypothetical test: Asks if debtor-licensee could hypothetically assign contract over objection of licensor
  - Enormous power to the licensor
  - Adopted by the Third, Fourth, Ninth and Eleventh Circuits
- Footstar approach: Debtor can assume the contract over the objections of the licensor, but a trustee cannot
- Supreme Court has noted the conflict but has not yet resolved the split

- Permits U.S. recognition of foreign insolvency proceeding
- What happens if the foreign jurisdiction does not protect IP license rights as per Section 365(n)
- The Fourth Circuit held that Section 365(n) should be applied in Chapter 15 cases to protect a licensee from a foreign debtor-licensor seeking to reject an IP license

- Prior to any bankruptcy filing, review the company's existing IP license agreements to ensure that the company is protected
- If a bankruptcy is filed, consult with bankruptcy counsel
- If the company is a licensee under an IP license agreement, and if the licensor files
  - Review the agreement and make a determination as to whether it is executory
  - If the agreement is executory, the company must decide whether it wants to retain its rights under the agreement
  - If the company decides to retain its rights under the agreement in accordance with Section 365(n), notice should be sent to the debtor of the company's decision
    - Need to oppose any motion to reject the agreement

- If the company is a licensor under an IP license agreement and the debtor-licensee files
  - Determine if agreement is executory
  - Does company want to object to assumption or assumption and assignment
  - Determine test to be applied
- If negotiating an IP license agreement on behalf of a licensee
  - Ensure that the license agreement specifically provides that the subject of the license agreement is “intellectual property” and that the licensee is entitled to all of the protections afforded licensees under Section 365(n)
  - Negotiate narrowly defined royalty payments and differentiate the royalty payments from other monetary obligations under the agreement
  - Use separate agreements for separate aspects of the transaction
  - Have an SPE hold the IP
  - Negotiate for perpetual, exclusive license

- If negotiating an IP license agreement on behalf of a licensor
  - Goals are to
    - Increase licensor's leverage if the licensee should file for bankruptcy
    - Control the licensee's ability to assume, or assume and assign, the license agreement (e.g., through choice of law provision or by identifying the specific assignments that should be prohibited)
  - Although the enforceability of such provisions is debatable, it is best practice to include in the agreement limitations on assignability and then to litigate the enforceability of the limitations if necessary
  - Include terms to enhance the licensor's ability to terminate the agreement before a bankruptcy is filed
    - If the license agreement is terminated prior to the bankruptcy filing, the agreement cannot be revived
    - It will not be part of the bankruptcy estate and therefore cannot be assumed



## Mark Salzberg

**Mark Salzberg is a partner in the Washington DC office and a member of the firm's Restructuring & Insolvency practice group. He focuses his practice on bankruptcy litigation, creditors' rights, debtor reorganizations and complex commercial litigation**

### About

Mark has extensive experience representing debtors, creditors' committees, financial institutions, secured and unsecured creditors, franchisors and distributors in bankruptcy matters throughout the United States. He has served as the lead appellate counsel in multiple bankruptcy appeals at both the district court and bankruptcy appellate panel levels and regularly counsels clients on intellectual property matters arising under the Bankruptcy Code. He is a past member of the Law360 Bankruptcy Editorial Advisory Board.

In addition to his bankruptcy work, Mark has represented parties in a wide variety of complex commercial litigation cases in both state and federal courts, including lender liability suits and other business tort actions, breach of contract, trade secret and noncompete actions.

Before joining Squire Patton Boggs, Mark was a partner at Foley & Lardner LLP. He was a member of the DC Bar Board of Governors from 2014-2015 and a member of the DC Bar Attorney/Client Arbitration Board from 2008-2014.

### About Squire Patton Boggs

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**Intellectual Property And Bankruptcy:  
Worlds Collide, But It's Not As Bad As You Think It Is**

**By: Mark A. Salzberg, Esq.  
Partner, Squire Patton Boggs (US) LLP**

1. Background on Bankruptcy
  - a. The most common types of bankruptcy cases are filed under Chapters 7, 11 and 13 of the Bankruptcy Code.
  - b. Petitions to recognize foreign insolvency proceedings are filed under Chapter 15.
  - c. The major concerns associated with intellectual property occur in Chapter 11 cases in which the debtor is either a licensor or licensee of intellectual property.
2. Intellectual Property under the Bankruptcy Code
  - a. Not all intellectual property is created equal in bankruptcy.
  - b. Section 101(35A) defines intellectual property as the following:
    - i. A trade secret;
    - ii. An invention, process, design, or plant protected under title 35;
    - iii. A patent application;
    - iv. A plant variety;
    - v. A work of authorship protected under Title 17; and
    - vi. A mask work protected under Chapter 9 of Title 17
  - c. The Bankruptcy Code's definition of intellectual property **does not** include trademarks, trade names or service marks.
    - i. Licensees of trademarks, trade names and service marks are at risk in the case of a bankruptcy by the licensor.
3. Treatment of Intellectual Property under the Bankruptcy Code
  - a. **Key question:** Many companies enter into license agreements to secure access to someone else's intellectual property. What happens to one of those license agreements if the owner of the intellectual property files a bankruptcy petition?
  - b. A license for intellectual property is typically considered to be an "executory contract."
    - i. An executory contract is a contract that requires some future or ongoing performance by both parties, where the outstanding obligations for the parties are *material*.
    - ii. *Countryman* test: Provides that an executory contract is "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other."<sup>1</sup>

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<sup>1</sup> Vern Countryman, *Executory Contracts in Bankruptcy, Part I*, 57 MINN. LAW REVIEW 439, 460 (1973).



- c. Fact-intensive inquiry. Some examples of material obligations under an intellectual property license are:
  - i. The obligation of the intellectual property owner to refrain from suing the licensee.<sup>2</sup>
  - ii. The obligation of the licensee to account for and pay royalties to the licensor.<sup>3</sup>
  - iii. The duty to maintain confidentiality on the part of the licensee.<sup>4</sup>
  - iv. The duty on the part of the licensor to indemnify and defend the licensee from infringement claims.<sup>5</sup>
- d. Exclusive vs. nonexclusive licenses
  - i. A nonexclusive license agreement is typically considered to be an executory contract.
  - ii. Exclusive intellectual property license agreements are sometimes considered to be analogous to a sale and are treated as nonexecutory.<sup>6</sup>
    - 1. Note that this is not a hard and fast rule and some courts have reached the opposite conclusion.<sup>7</sup>
- e. Can a nondebtor party to an executory contract terminate the contract during the bankruptcy?
  - i. Short answer: Not without court approval.
  - ii. The debtor's rights under the executory contract become part of the bankruptcy estate.<sup>8</sup> The automatic stay prevents creditors from taking many different types of actions against the debtor or its property, including obtaining possession of, or exercising control over, property of the bankruptcy estate.<sup>9</sup>

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<sup>2</sup> *E.g.*, *Everex Sys., Inc. v. Cadtrak Corp. (In re CFLC, Inc.)*, 89 F.3d 673, 677 (9th Cir. 1996) (holding that the licensor's continuing obligation to refrain from suing the licensee for infringement was a material unperformed obligation, and that an exclusive license agreement was therefore executory); *In re Access Beyond Techs., Inc.*, 237 B.R. 32, 44 (Bankr. D. Del. 1999) (holding that an exclusive patent license agreement was executory because the licensor's duty to forbear from suing the licensee for infringement was, in and of itself, a material ongoing performance obligation).

<sup>3</sup> *E.g.*, *In re Petur U.S.A. Instr. Co.*, 35 B.R. 561, 563 (Bankr. W.D. Wash. 1983) ("In this instance, the Court concludes that the license agreement is an executory contract. The debtor is under a number of continuing obligations, including providing product, information and know-how, and consulting services. Conversely, Petur of Canada is obligated to pay royalties on sales for the remaining term of the agreement. The failure to perform by either party would constitute a material breach excusing performance by the other.").

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

<sup>5</sup> *E.g.*, *In re Chipwich, Inc.*, 54 B.R. 427, 430 (Bankr. S.D.N.Y. 1985) ("Additionally, Farmland is required to protect the debtor's rights in the licensed trademarks. Manifestly, the licenses in the instant case are executory as to both the debtor and Farmland and, therefore, they are executory contracts within the meaning of 11 U.S.C. § 365(a).").

<sup>6</sup> *E.g.*, *In re Kmart Corp.*, 290 B.R. 614, 619 (Bankr. N.D. Ill. 2003) ("Accordingly, an exclusive intellectual property license would be more likely to constitute a sale because an exclusive license confers upon the licensee (and divests the licensor of) all or some portion of the ownership rights and interests associated with the intellectual property pursuant to well-established principles of patent[,] copyright and trademark law" (citations omitted)).

<sup>7</sup> See *In re Access Beyond*, *supra* n. 3, 237 B.R. at 44.

<sup>8</sup> See 11 U.S.C. § 541(a)(1) (the commencement of a bankruptcy case creates an estate, which is comprised of, among other things, "all legal or equitable interests of the debtor in property as of the commencement of the case"); see also *Cinicola v. Scharffenberger*, 248 F.3d 110, 121 (3d Cir. 2001) (explaining that a debtor's interest in an executory contract is included in the property of the bankruptcy estate, as defined by 11 U.S.C. § 541(a)(1)).

<sup>9</sup> See 11 U.S.C. § 362(a).

- iii. Creditor can seek relief from the automatic stay.<sup>10</sup>
      - 1. However, such relief is rarely granted to allow a nondebtor party to terminate an executory contract, especially when that contract is valuable to the estate.
  - 4. License Agreements as Executory Contracts
    - a. What does it mean if the intellectual property license agreement is executory?
    - b. Section 365 of the Bankruptcy Code gives the debtor three options regarding its executory contracts.<sup>11</sup>
      - i. The debtor may *reject* an executory contract.
        - 1. Rejection constitutes a breach of the contract, and relieves the debtor from any future obligations under that contract.<sup>12</sup>
      - ii. Second, the debtor may *assume* an executory contract, meaning that the debtor will continue to perform under the contract. An executory contract must be assumed in whole, meaning that the debtor cannot assume those portions of the contract that it likes, and reject those portions it finds burdensome.<sup>13</sup> Assumption requires the debtor to:
        - 1. Cure, or provide adequate assurance that it will promptly cure, defaults (subject to certain exceptions not pertinent to this discussion) under the contract;
        - 2. Compensate, or provide adequate assurance that it will promptly compensate, the other party to the contract for any actual pecuniary losses resulting from prior defaults; and
        - 3. Provide adequate assurance of the debtor's ability to fully perform all of its future obligations under the contract.<sup>14</sup>
      - iii. Third, the debtor may *assume and then assign* an executory contract, and the assignee would assume the debtor's obligations under the contract.<sup>15</sup>
      - iv. The assignee of the contract must therefore provide adequate assurance of its ability to fully perform all of its future obligations under the contract.<sup>16</sup>
    - c. When does the decision need to be made?
      - i. In a Chapter 11 case, the debtor may assume or reject (or assume and assign) an executory contract any time up until confirmation of a plan of reorganization or liquidation.
      - ii. The nondebtor party to the contract can request that the court compel the debtor to make an earlier election, but courts are reluctant to grant such requests.<sup>17</sup>

<sup>10</sup> See 11 U.S.C. § 362(d) (permitting relief from the automatic stay (1) for “cause”; or (2) with respect to the stay of an act against property, if the debtor does not have equity in the property and the property is not necessary to an effective reorganization).

<sup>11</sup> Section 365 also addresses unexpired leases, but such leases are not pertinent to the analysis of intellectual property license agreements. Accordingly, this chapter addresses only executory contracts, although many of the rules regarding unexpired leases discussed below are the same.

<sup>12</sup> 3 COLLIER ON BANKRUPTCY ¶ 365.03[1] (15th ed. rev., 2003).

<sup>13</sup> *E.g.*, Schlumberger Res. Mgmt. Servs. v. Cellnet Data Sys. (*In re Cellnet Data Sys.*), 327 F.3d 242, 249 (3d Cir. 2003) (“Under the Bankruptcy Code, a trustee may elect to reject or assume its obligations under an executory contract. This election is an all-or-nothing proposition—either the whole contract is assumed or the entire contract is rejected.”).

<sup>14</sup> 11 U.S.C. § 365(b)(1)(A)-(C).

<sup>15</sup> 11 U.S.C. § 365(f).

<sup>16</sup> 11 U.S.C. § 365(f)(2).

<sup>17</sup> 11 U.S.C. § 365(d)(2).

5. What Happens if the Debtors Wants to Reject an Intellectual Property License?
- a. Section 365(n) provides that if a debtor rejects an executory contract under which the debtor is a licensor of intellectual property, the licensee may either:
    - i. Elect to treat the contract as terminated (*i.e.*, breached), and file a proof of claim for damages flowing from the debtor's termination of the contract;<sup>18</sup>
    - or
    - ii. Retain its rights to use the intellectual property under the contract for the duration of the contract and for any extension periods provided for by the contract.<sup>19</sup>
  - b. If the nondebtor licensee elects to retain its rights to the intellectual property, the licensee must continue to make all royalty payments due under the original term of the contract, and any term extensions that the licensee elects to exercise.<sup>20</sup>
  - c. The debtor-licensor must, upon written request of the licensee
    - i. Comply with any contractual requirement to provide the intellectual property to the licensee, and
    - ii. Refrain from interfering with the rights of the licensee to the intellectual property.<sup>21</sup>
  - d. Hints
    - i. The licensee should not wait for the debtor-licensor's rejection of the contract if it has already decided that it wants to retain its rights in the intellectual property.
    - ii. The licensee should be proactive and provide written notice to the debtor-licensor, as the debtor is, upon receipt of the notice, required to either
      - 1. Continue to perform under the contract or
      - 2. Comply with any contractual requirement to provide the intellectual property to the licensee, as well as
      - 3. Refrain from interfering with the rights of the licensee to the intellectual property.<sup>22</sup>
  - e. Downsides of making Section 365(n) election
    - i. The licensee waives any right of setoff that it may have with respect to the license agreement and also waives its right to assert an administrative expense claim arising from the performance of the contract.<sup>23</sup>
    - ii. The rights granted to the licensee under section 365(n) are restricted to the intellectual property: they do not extend to other benefits it was receiving under the agreement, such as the debtor's assistance.<sup>24</sup>
6. What Protections are given Trademark Licensees?

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<sup>18</sup> Section 365(g) of the Bankruptcy Code provides that the rejection of an executory contract constitutes a breach of the contract occurring immediately prior to the filing of the bankruptcy

<sup>19</sup> 11 U.S.C. § 365(n)(1).

<sup>20</sup> 11 U.S.C. § 365(n)(2)(B).

<sup>21</sup> 11 U.S.C. § 365(n)(3).

<sup>22</sup> 11 U.S.C. § 365(n)(4).

<sup>23</sup> 11 U.S.C. § 365(n)(2)(C).

<sup>24</sup> *E.g.*, *Biosafe Int'l v. Controlled Shredders (In re Szombathy)*, Case Nos. 94 B 15536, 95 A 01035, 1996 Bankr. LEXIS 888, at \*31 (Bankr. N.D. Ill. July 9, 1986), *rev'd on other grounds*, 1997 U.S. Dist. LEXIS 5168 (N.D. Ill. Apr. 10, 1997) ("Moreover, the licensee cannot compel the debtor to perform any affirmative obligations under the agreement once it has been rejected.").

- a. Some courts held that Sections 101(35A) and 365(n) created the inference that Congress did not intend to protect a trademark licensee in the same way in which an intellectual property licensee is protected.<sup>25</sup>
  - b. Some courts rejected this “negative inference” and held that bankruptcy courts have the authority to permit a nondebtor to retain a trademark license based upon the equities of the case.<sup>26</sup>
  - c. The Seventh Circuit rejected the negative inference but held that a nondebtor’s right to continue to use a trademark license is based upon Section 365(g).<sup>27</sup>
  - d. On May 20, 2019, the Supreme Court issued its opinion in *Mission Product Holdings, Inc. v. Tempnology, LLC*.<sup>28</sup>
    - i. This was a victory for trademark licensees.
    - ii. The Court rejected the negative inference and sided with the Seventh Circuit’s holding that rejection of an executory contract simply constitutes a prepetition breach of that contract and does not act as either a contract rescission or a termination.
    - iii. Justice Sotomayor opened the door to Congress to tailor post-rejection provisions for trademark licensees, similar to post-rejection provisions for IP licensees under Section 365(n).
7. Debtor/Licensee Assignment of Licensed Rights
- a. A contract generally cannot prohibit assignment.<sup>29</sup>
  - b. However, Section 365(c)(1) provides one exception to this general rule of assignability.
    - i. Section 365(c)(1) provides that a debtor “may not assume or assign” an executory contract or unexpired lease if “**applicable law** excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor” and “such party does not consent to such assumption or assignment.”<sup>30</sup>
    - ii. The term “applicable law,” includes patent laws—and under U.S. patent law, a nonexclusive license is considered to be personal and not assignable without the patent owner’s consent.<sup>31</sup>

<sup>25</sup> *E.g., HQ Global Holdings, Inc.*, 290 B.R. 507, 513 (Bankr. D. Del. 2003) (“[S]ince the Bankruptcy Code does not include trademarks in its protected class of intellectual property, *Lubrizol* controls and the Franchisees’ right to use the trademark stops on rejection.”).

<sup>26</sup> *E.g., In re Crumbs Bake Shop, Inc.*, 522 B.R. 766, 771-72 (Bankr. D.N.J. 2014) (“Congress intended the bankruptcy courts to exercise their equitable powers to decide, on a case by case basis, whether trademark licensees may retain the rights listed under § 365(n). Here, the Court finds that it would be inequitable to strip the [] Licensees of their rights in the event of a rejection, as those rights had been bargained away by Debtors.”).

<sup>27</sup> *Sunbeam Prods. v. Chicago Am. Mfg., LLC*, 686 F.3d 372, 377-78 (7th Cir. 2012) (“What § 365(g) does by classifying rejection as breach is establish that in bankruptcy, as outside of it, the other party’s rights remain in place. After rejecting a contract, a debtor is not subject to an order of specific performance . . . [N]othing about this process implies that any rights of the other contracting party have been vaporized”).

<sup>28</sup> 139 S. Ct. 397 (2019).

<sup>29</sup> *See* 11 U.S.C. § 365(f)(1) (providing that a trustee may assign an executory contract or unexpired lease “notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts or conditions the assignment of such contract or lease”).

<sup>30</sup> 11 U.S.C. § 365(c)(1).

<sup>31</sup> *E.g., Cargill, Inc. v. Nelson (In re LGX, LLC)*, 2006 Bankr. LEXIS 635, at \*11 (B.A.P. 10th Cir. Jan. 13, 2006) (“Bankruptcy courts have held that federal common law preventing the non-consensual assignment of patent licenses constitutes ‘applicable law’ that prohibits a debtor’s assumption and assignment of the license over a patent owner’s objection under § 365(c)(1)”);

- c. What are the implications of Section 365(c)(1)?
  - i. Short answer: It depends on where the bankruptcy case is filed.
  - ii. Circuit split based upon the phrase “or assign”
  - iii. Actual test: Section 365(c)(1) bars the assumption of a contract *only if* the debtor actually intends to also assign the contract.
    1. These courts read “or” to include “and,” and have held that unless the debtor actually intends to assume *and* assign, section 365(c)(1) does not bar assumption.
    2. Under the actual test, licensors cannot use section 365(c)(1) to prevent assumption of their license agreements, and may have to continue to permit the debtor to perform under the agreements.
    3. The circuit courts applying the actual test include the First<sup>32</sup> and Fifth<sup>33</sup> Circuits, although lower courts in the Seventh,<sup>34</sup> Eighth,<sup>35</sup> and Tenth<sup>36</sup> Circuits appear to follow the actual test as well.
  - iv. Hypothetical test: Section 365(c)(1) bars the assumption of a contract, *even if* the debtor has no intention of assigning the agreement.
    1. These courts ask whether, under section 365(c)(1), a debtor could *hypothetically* assign the agreement over the objection of the licensor.
    2. The hypothetical test provides enormous power to the licensor.

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Everex Sys., Inc. v. Cadtrak Corp. (*In re CFLC, Inc.*), 89 F.3d 673, 679 (9th Cir. 1996) (under federal law, nonexclusive patent license that is silent as to assignability is presumed not to be assignable).

<sup>32</sup> *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489, 493 (1st Cir. 1997) (rejecting the hypothetical test and explaining that §§ 365(c) and (e) call for a case-by-case inquiry as to whether the nondebtor party is *actually* being forced to accept performance under its executory contract from someone other than the debtor party with whom it originally contracted); *see also In re Leroux*, Case No. 92-20404-WCH, 1997 Bankr. LEXIS 971, at \*28-29 (Bankr. D. Mass. June 30, 1997) (“[I]t appears that for motions to assume or reject that implicate 11 U.S.C. § 365(c) and (e), the standard is the ‘actual performance’ test, as coined by the First Circuit.”).

<sup>33</sup> *In re Mirant Corp.*, 440 F.3d 238, 249-50 (5th Cir. 2006) (adopting the actual test to determine the “applicable law” for an executory contract); *see also In re Jacobsen*, 465 B.R. 102, 107-08 (Bankr. N.D. Miss. 2011) (noting that the court “rejects the ‘hypothetical test’ approach when there is a clear absence of an intent to assign the executory contract or the unexpired lease”); *In re Virgin Offshore United States*, Case No. 11-13028, 2012 Bankr. LEXIS 5642, at \*13 (Bankr. E.D. La. Dec. 6, 2012) (“In *Mirant*, the Fifth Circuit adopted the ‘actual or as applied[.]’ test. . . . The actual test provides that if no assignment has taken place or will take place, the exception for non-assignable contracts does not apply.”).

<sup>34</sup> *In re Edison Mission Energy*, Case No. 12-49219, 2013 Bankr. LEXIS 3872, at \*30-32 (Bankr. N.D. Ill. Sept. 16, 2013) (“The Court also finds that the actual test is more congruous with fundamental bankruptcy policy: the maximization of the value of the debtor’s estate. . . . The hypothetical test, by contrast, would preclude the assumption of an advantageous contract to the detriment of the entire creditor body and the debtor’s reorganizing efforts. This is so even when the debtor has no plans to assign the contract. Thus, this Court rejects the hypothetical test approach and will apply the actual test herein.”).

<sup>35</sup> *In re GP Expl. Airlines, Inc.*, 200 B.R. 222, 231-33 (Bankr. D. Neb. 1996) (“On facts like those before this court, where a debtor in possession simply wants to retain its prepetition executory contracts and to perform thereunder, the better reasoned result is to permit assumption, regardless of whether the contract can be assumed and assigned to a third party under applicable law.”).

<sup>36</sup> *In re Aerobox Composite Structures*, 373 B.R. 135, 142 (Bankr. D.N.M. 2007) (“Thus, where the debtor-in-possession seeks to assume, or, as is the situation in the instant case, where the debtor-in-possession has neither sought to assume nor reject the executory contract but simply continues to operate post-petition under its terms, 11 U.S.C. § 365(c)(1) does not prohibit assumption of the contract by the debtor-in-possession and cannot operate to allow the non-debtor party to the executory contract to compel the Debtor to reject the contract. In reaching this conclusion, the Court finds that the ‘actual test’ articulated in *Cambridge Biotech*, and the reasoning of the court in *Footstar*, is the better approach to § 365(c)(1) when determining whether a debtor-in-possession is precluded from assuming an executory contract.”).

3. The circuit courts applying the hypothetical test include the Third,<sup>37</sup> Fourth,<sup>38</sup> Ninth,<sup>39</sup> and Eleventh<sup>40</sup> Circuits.
- v. *Footstar* approach: The bankruptcy court in the Southern District of New York held that the debtor in possession may assume an executory contract over the objections of the nondebtor party.<sup>41</sup>
  1. The court based its holding on the lead-in language in section 365(c)(1), which provides that the “trustee may not assume or assign ... [emphasis added].”
  2. Thus, as long as the debtor seeks to assume an intellectual property license agreement, rather than a trustee, the *Footstar* approach would permit the assumption.
- vi. The Supreme Court has noticed the split.
  1. *N.C.P. Mktg. Grp. v. BG Star Prods.*, 129 S. Ct. 1577, 1578 (2009) (“The division in the courts over the meaning of § 365(c)(1) is an important one to resolve for Bankruptcy Courts and for businesses that seek reorganization. This petition for certiorari, however, is not the most suitable case for our resolution of the conflict. Addressing the issue here might first require us to resolve issues that may turn on the correct interpretation of antecedent questions under state law and trademark-protection principles. For those and other reasons, I reluctantly agree with the Court’s decision to deny

<sup>37</sup> *In re West Elecs.*, 852 F.2d 79, 83 (3d Cir. 1988) (applying the hypothetical test and holding that because the government military contract could not be assigned to a third party under applicable law, the debtor in possession could not assume the contract); *see also* *Huron Consulting Servs., LLC v. Physiotherapy Holdings, Inc.* (*In re Physiotherapy Holdings, Inc.*), 538 B.R. 225, 231-233 (D. Del. 2015) (“Because the License Agreement is assignable under 11 U.S.C. § 365(c), the Third Circuit’s ‘hypothetical test’ dictates that it is also assumable”); *In re Trump Entm’t Resorts, Inc.*, 526 B.R. 116, 125 (Bankr. D. Del. 2015) (holding that under the hypothetical test “the Debtors are prohibited from assuming or assigning the Trademark License Agreement, despite the fact that the Debtors have no immediate plans to assign the agreement to a third party.”).

<sup>38</sup> *RCI Tech. Corp. v. Sunterra Corp.* (*In re Sunterra*), 361 F.3d 257, at 266-67, 271—72 (4th Cir. 2004) (determining that under § 365(c), the debtor in possession was precluded from assuming a nonexclusive software license because the licensee’s consent to assignment did not constitute the necessary consent to assumption); *see also* *Warner v. Warner*, 480 B.R. 641, 649-50 (Bankr. N.D. W. Va. 2012) (“Section 365(c)(1) allows non-debtor parties to prevent the trustee from assuming or assigning the rights of the debtor as long as the contract is an agreement where substitute performance is not permitted.”).

<sup>39</sup> *Pearlman v. Catapult Entm’t* (*In re Catapult Entm’t, Inc.*), 165 F.3d 747, 749-50 (9th Cir. 1999) (“In other words, the statute by its terms bars a debtor in possession from assuming an executory contract without the nondebtor’s consent where applicable law precludes assignment of the contract to a third party. The literal language of § 365(c)(1) is thus said to establish a ‘hypothetical test’: a debtor in possession may not assume an executory contract over the nondebtor’s objection if applicable law would bar assignment to a hypothetical third party, even where the debtor in possession has no intention of assigning the contract in question to any such third party.”); *see also* *Maunakea v. Hu* (*In re Maunakea*), 448 B.R. 252, 264 (D. Haw. 2011) (discussing the Ninth Circuit’s adoption of the hypothetical test to determine whether an intellectual property license can be assumed by a debtor in possession under § 365(c)(1)).

<sup>40</sup> *City of Jamestown v. James Cable Partners, Ltd. P’ship* (*In re James Cable Partners*), 27 F.3d 534, 537-38 (11th Cir. 1994) (affirming the holding that a cable operator franchisee, as the debtor in possession, could assume a cable franchise without franchising authority consent, despite a local cable ordinance that prohibited assignment, which was insufficient to constitute applicable law under § 365(c)(1)); *see also* *Moe’s Franchisor, LLC v. Taylor Inv. Partners II, LLC* (*In re Taylor Inv. Partners II, LLC*), 533 B.R. 837, 842-43 (Bankr. N.D. Ga. 2015) (“The 11th Circuit’s pronouncement—that § 365(c)(1) would prevent a debtor in possession from assuming an executory contract if applicable law would excuse the other party to the contract from accepting performance from a party other than the debtor in possession—is not *dicta*”).

<sup>41</sup> *In re Footstar, Inc.*, 323 B.R. 566, 570 (Bankr. S.D.N.Y. 2005) (“Section 365(c)(1) states that ‘the trustee may not assume or assign . . .’ (emphasis supplied). The key word is ‘trustee.’ The statute does not say that the debtor or debtor in possession may not assume or assign—the prohibition applies on its face to the ‘trustee’ . . . . Nothing in the Bankruptcy Code prohibits the debtors from assuming the Agreements.”).

certiorari. In a different case the Court should consider granting certiorari on this significant question.”).

8. Foreign Insolvency Proceedings

- a. Chapter 15 permits a foreign representative of a non-U.S. insolvency proceeding to seek recognition of the foreign proceeding in the United States.
- b. **Question:** What happens if the foreign debtor is the licensor of intellectual property to a U.S.-based company, and the laws of the foreign proceeding do not protect intellectual property licensees as section 365(n) does? Is the U.S.-based licensee at risk of losing its license?
- c. *Jaffé v. Samsung Elecs. Co.*, 737 F.3d 14, 17 (4th Cir. 2013) – Section 365(n) should be applied in Chapter 15 cases to protect a licensee from a foreign debtor-licensor seeking to reject an intellectual property license.

9. Strategies

- a. Prior to any bankruptcy filing, review the company’s existing intellectual property license agreements to ensure that the company is protected.
  - i. Ensure that these agreements adequately address the section 365(n) concerns.
  - ii. If the agreements are lacking, counsel should ensure that all necessary provisions are included in the agreements if and when the agreements are renegotiated.
- b. Once a bankruptcy is filed, consult with bankruptcy counsel (in-house or outside counsel).
- c. If the company is a licensee under an intellectual property license agreement, and if the licensor files a bankruptcy petition:
  - i. Review the agreement and make a determination as to whether the agreement is executory.
  - ii. If the agreement is executory, the company must decide whether it wants to retain its rights under the agreement.
  - iii. If the company decides to retain its rights under the agreement in accordance with section 365(n), notice should be sent to the debtor of the company’s decision.
    1. Need to oppose any motion to reject the agreement.
- d. If the company is a licensor under an intellectual property license agreement and the debtor-licensee files a bankruptcy case:
  - i. Review the agreement and make a determination as to whether the agreement is executory.
  - ii. Determine whether the company has an interest in objecting to either an assumption of the agreement by the debtor, or an assumption and subsequent assignment by the debtor.
  - iii. Review the prevailing case law in the circuit in which the bankruptcy case is filed and understand whether the hypothetical test, the actual test, or the *Footstar* test will be applied.
- e. What to do if negotiating an intellectual property license agreement for licensee.
  - i. Ensure that the license agreement specifically provides that the subject of the license agreement is “intellectual property” as defined by § 101(35A). The license agreement should also specifically provide that the company,

- as licensee, is entitled to all of the protections afforded licensees under § 365(n). The licensor should specifically acknowledge both of these points in the license agreement.
- ii. Negotiate narrowly defined royalty payments and differentiate the royalty payments from other monetary obligations under the agreement.
  - iii. If the license agreement involves licensing software, negotiate a separate escrow agreement for the software source code. The escrow agreement would specify that the escrow agent is permitted to release the source code to the licensee upon certain conditions, including the filing of a bankruptcy petition by the licensor, an event of default under the license agreement, or the rejection of the license agreement by the licensor.
  - iv. Consider taking a security interest in the intellectual property.
  - v. Consider negotiating separate agreements for separate aspects of the transaction. This would prevent the licensor from arguing that the license is part of a larger, integrated transaction, and would minimize the risk that the license agreement will be rejected without the company being afforded the protections under section 365(n).<sup>42</sup>
  - vi. Consider the benefits of negotiating a perpetual, exclusive license, because these are often treated as a sale and conveyance of a property interest, and therefore not subject to rejection.
  - vii. Consider having a bankruptcy remote entity hold the intellectual property and be the licensor under the lease agreement. This will make it more difficult for the intellectual property to become subject to a bankruptcy proceeding in the first instance.
- f. What to do if negotiating an intellectual property license agreement for licensor.
- i. Negotiate the license agreement with an eye toward increasing its leverage if the licensee should file for bankruptcy.
  - ii. Main concern would be to control the licensee's ability to assume, or assume and assign, the license agreement.
    - 1. Consider including a provision in the agreement that the laws of a certain federal circuit apply. The designated circuit would be one of those applying the hypothetical test, because the hypothetical test maximizes a licensor's ability to prevent assumption of a license agreement.
  - iii. To hedge against the chance that the licensee will file in a circuit applying the actual test, consider identifying the specific assignments that should be prohibited.
    - 1. For instance, the licensor may not want the intellectual property license being assigned to one of its competitors or assigned to a company that would be competing with another licensee operating in a specific geographic area.
    - 2. Although the enforceability of such provisions is debatable, it is best practice to include in the agreement limitations on

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<sup>42</sup> However, if the license is in fact an integral part of an overall transaction, counsel should have the company aggregate the license and all other terms of the transaction into a single agreement, as opposed to separate agreements. This would prevent the licensor from "cherry picking" those agreements it wants to assume and those it wants to reject in the event of bankruptcy.



assignability and then to litigate the enforceability of the limitations if necessary.

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