



*Licensing Intellectual Property from and to*  
**Distressed Companies**

By Peter N. Barnes-Brown



MORSE  
BARNES-BROWN  
PENDLETON <sup>PC</sup>

[mbbp.com](http://mbbp.com)

The law firm built for business.<sup>SM</sup>



The law firm built for business.<sup>SM</sup>

Reservoir Place  
1601 Trapelo Road, Suite 205  
Waltham, MA 02451  
781-622-5930

[mbbp.com](http://mbbp.com)

Business | Technology & IP | Employment & Immigration | Taxation

## I. Scope Note

Among the most valuable business assets in the economy today are intellectual property assets. They exist in various forms and are protected by various intellectual property regimes, patent, copyright, trade secret and trademark being the most significant. They are commercialized - that is, converted into revenues - predominantly by means of licensing.

If one of the parties to an intellectual property license agreement experiences financial difficulty and seeks the protection of the bankruptcy laws, the rights of the other party to that license will change. The nature of that change, and the extent to which the non-bankrupt party is able to retain the benefit of the rights for which it negotiated in the license agreement, are determined by an interplay among bankruptcy law, intellectual property law and other laws, and will depend on various factors, including whether the debtor is the licensor or the licensee, the type of intellectual property involved, and the nature of the license.

This article sets forth, from the perspective of a business and licensing attorney who does not practice in the bankruptcy area, the governing law and its application and provides practice and drafting recommendations to assist the licensor and the licensee to achieve their original objectives if the other party becomes financially distressed and, ultimately, files for bankruptcy protection.

## II. The Bankruptcy Setting

- A. **Overriding Policy Objectives.** The primary goal of a Chapter 11 business reorganization is rehabilitation of the debtor. In support of that basic goal, the bankruptcy laws are applied to afford the debtor a "fresh start", as a result of the ability to discharge or restructure most debts and to reject or modify burdensome contracts, and a "breathing spell" in which it can restructure its debts without continued pressure from its creditors.
- B. **General Structure.** All pre-petition creditors and other stakeholders are divided into classes, typically secured creditors, unsecured creditors, subordinated creditors, and equity holders. Each class is assigned a priority, and higher classes are entitled to be paid in full before a lower class is paid anything. All creditors within a class are treated equally and paid, on a pro rata basis, the same amount. After the debts are restructured or discharged, the debtor can emerge from Chapter 11 and perform the restructured payment schedule. Goods and services contracted for by the debtor post-petition, including continued performance under pre-petition contracts, are "administrative expenses" under the Bankruptcy Code and are availed the highest priority among creditors of the bankruptcy estate.
- C. **The Bankruptcy Estate.** Most bankruptcy proceedings are commenced voluntarily by the filing of a petition,<sup>1</sup> which has two immediate effects. First, it creates a bankruptcy estate containing substantially all of the debtor's interests in property at the time of the filing and any proceeds of that property and additional interests in property the debtor<sup>2</sup> may acquire later.<sup>3</sup> If a license is not property of the debtor at the time the petition is filed, it does not become part of the bankruptcy estate. Therefore, if a license agreement

---

has been properly terminated prior to bankruptcy, it will not become subject to the bankruptcy proceeding.<sup>4</sup>

- *Practice Tip* - Licensor: Make late payment a default or breach, and make termination a remedy for material or repeated payment breaches.
- *Practice Tip* - Licensor: Consider making deterioration in the financial condition of the licensee a default or breach, and make termination a remedy.
- *Practice Tip* - Licensor: At the first signs of financial distress of a licensee, raise the level of oversight and stay on top of the situation.
- *Practice Tip* - Licensor: Consider "going dark" bans, i.e., make cessation or substantial reduction of normal business operations a breach.
- *Practice Tip* - Licensor: Provide for shorter rather than longer terms - either by automatic termination unless mutually agreed renewals, or by automatic renewal subject to notice of nonrenewal, although former may be preferable in bankruptcy.

- D. **The Automatic Stay.** Second, filing a petition also triggers one of the most powerful defenses afforded by the Bankruptcy Code, the automatic stay. All of the debtor's pre-petition creditors are automatically enjoined from initiating any proceeding or directly or indirectly taking any action seeking to collect money from the debtor or execute on its assets.<sup>5</sup> Thereafter, any initiation of proceedings based on pre-petition (or even many post-petition) events, or any resumption of pending proceedings, must be approved by the bankruptcy court.
- E. **Ipso Facto Clauses.** So-called "ipso facto" clauses, or contract provisions that permit termination or modification upon the insolvency or bankruptcy of a party to that contract, are made generally unenforceable by Bankruptcy Code Section 365(e)(1). However, Bankruptcy Code Section 365(e)(2) provides an exception to this general rule of unenforceability for executory contracts as to which applicable non-bankruptcy law "excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to the trustee or to an assignee of such contract or lease," without regard to whether the contract prohibits or restricts assignment.
- *Practice Tip* - Licensor: Include an ipso facto clause in agreements, even if it may be held not to be enforceable.
- F. **Debtor's Right to Use, Sell or Lease Property of the Estate.** The debtor is authorized by Section 363 of the Bankruptcy Code to operate the business and use, sell or lease the property of the estate.<sup>6</sup> "Property" does not include an interest in agreements that are still being performed (see discussion of Executory Contracts below).
- G. **Exclusive Licenses.** Exclusive licenses (both copyright<sup>7</sup> and patent<sup>8</sup>) have been held to be completed transfers of an absolute right under the Copyright Act. Such a right is property of the bankrupt estate and may be sold by the debtor pursuant to Bankruptcy Code Section 363.<sup>9</sup> In the event of such a sale, the licensee could well discharge its future royalty obligations by the payment of cents on the dollar. Although Section 363 conditions the right to sell upon "adequate protection" being provided for the interests of
-

any entity that has an interest in the property being sold, licensors of intellectual property should not want to subject their interest in their crown jewels to the tender mercies of the bankruptcy court. Accordingly, copyright owners should resist the grant of exclusive licenses unless the business context permits no other solution.

- *Practice Tip* - Licensor: Avoid "exclusive" licenses, if feasible.
- *Practice Tip* - Licensor: If an exclusive license is necessary, consider taking and perfecting a security interest in the licensee's property interest created thereby and its proceeds.
- *Practice Tip* - Licensor: Even if a license agreement has some attributes of exclusivity, have both parties acknowledge that the agreement is executory and specify the continuing obligations on each side that make it so.

### III. Executory Contracts In General

- A. **In General.** In support of the overriding goal of rehabilitation of the debtor, there is a longstanding principle of bankruptcy law that a trustee in bankruptcy (or debtor in possession) should not be compelled to assume burdensome obligations under pre-petition contracts. Accordingly, an executory contract<sup>10</sup> does not become an asset of the estate until it is assumed pursuant to Section 365(a) of the Bankruptcy Code.<sup>11</sup> However, under Section 365(a) of the Bankruptcy Code, a debtor may assume or reject any executory contract, subject to the court's approval.<sup>12</sup> Under Section 365(f), the debtor may (except for non-assignable contracts as provided in Section 365(c), discussed below in paragraph III.C) assign any executory contract, notwithstanding any contractual or statutory provision prohibiting assignment.<sup>13</sup> Each course of action is subject to conditions and gives rise to a separate set of obligations.
- B. **Assumption.** Assumption of a contract means simply that the obligations of both parties under the contract will continue unchanged. In order to assume an executory contract which is in default, the debtor must (1) cure, or provide adequate assurance that it will promptly cure, any outstanding defaults, (2) compensate, or provide adequate assurance that it will promptly compensate, any party other than the debtor to such contract (i.e., the non-debtor licensor or licensee) for any actual pecuniary loss resulting from such default, and (3) provide adequate assurance of its future performance.<sup>14</sup> The assumption of an executory contract transforms it into a post-petition obligation constituting an administrative expense of the estate, with the highest priority for payment out of the bankruptcy estate.
- *Practice Tip* - Licensor: Provide that, pursuant to Bankruptcy Code 365(c)(1), agreement is not assumable in bankruptcy without consent; recite facts to show reliance on particular licensee.
- C. **Rejection.** Rejection of an executory contract constitutes a pre-petition breach of contract, for which the nondebtor has an unsecured claim against the bankrupt estate for damages as of immediately before the date of filing,<sup>15</sup> but has no right to specific performance.

- D. **Assignment.** In order to assign an executory contract, a debtor must (1) assume the contract in accordance with Section 365(b)(1) (including its requirements of curing defaults and providing assurances against future defaults), and (2) provide adequate assurance of future performance by the assignee.<sup>16</sup> Despite Section 365(f) (see discussion at paragraph I.A above), the licensor may want to provide that pursuant to Bankruptcy Code 365(c)(1) the agreement is not assignable without the licensor's consent, and recite the attributes of the licensee that make it uniquely acceptable as a licensee of the particular intellectual property.
- *Practice Tip* - Licensor: Provide that, pursuant to Bankruptcy Code 365(c)(1), agreement is not assignable by licensee without consent; recite facts to show reliance on particular licensee.
  - *Practice Tip* - Licensor: Consider provisions that would cause termination upon an acquisition or change in control of licensee: outright prohibition, limited on permitted license volume, departure of key person(s).
- E. **Definition of Executory Contracts.** The Bankruptcy Code does not define "executory contract". However, the legislative history indicates that Congress intended the term to mean a contract "on which performance remains due to some extent on both sides." The courts have generally adopted the definition proffered by Professor Countryman: 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>17</sup> An agreement which is executory at the time of the bankruptcy petition but becomes non-executory post-petition may thereby become unassumable.<sup>18</sup>
- *Practice Tip* - Both Parties: Review the remaining obligations under executory agreements to determine whether avoidance of executoriness by completing performance would be feasible and desirable.
- F. **Intellectual Property Licenses as Executory Contracts.** Intellectual property license agreements have been found by many courts to be executory. However, whether a license agreement is executory will depend on its particular terms, specifically the extent to which the parties have continuing obligations as of the petition date.

Trademark licenses are usually executory because the licensor will have continuing quality control obligations and the licensee will have payment and other continuing performance obligations.<sup>19</sup>

Copyright licenses and publishing agreements are also usually deemed executory, although these determinations are also fact-dependent. Where, for example, a licensor's only continuing role is to receive royalty checks<sup>20</sup> or an author has no remaining obligations after conveying rights in the agreement, the agreements were found not executory.<sup>21</sup> However, where the licensor has significant continuing obligations, the agreement is executory. For example, in *In re Select-A-Seat Corp.*,<sup>22</sup> the court held an exclusive software license agreement to be executory because of the debtor/licensor's ongoing obligation to pay royalties.

---

Patent license agreements are analyzed in a similar fashion: any material remaining obligation will make an agreement executory. Therefore, a licensor's obligations to defend infringement claims, to notify the licensee of infringement actions, to continuously give the licensee most favored nation pricing, and to comply with an exclusivity obligation have all been held to render a contract executory.<sup>23</sup> In *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*,<sup>24</sup> the court found a non-exclusive license agreement to be executory as to the licensor because it was obligated to notify the licensee of and defend any patent infringement suit, to give the licensee most favored nation pricing and to indemnify the licensee for any misrepresentation or breach of warranty. The agreement was executory as to the licensee because it was obligated to deliver written royalty reports, keep books of account subject to inspection, and treat the licensed technology as confidential.

In "channel" relationships, where the other party is not the end user but a reseller or other intermediary, making the other party a sales agent performing services for a commission, rather than licensing the intellectual property to the channel partner with the right to grant sublicenses, will remove the agreement from the reach of Section 365(n).

- *Practice Tip* - Licensor: In "channel" relationships, consider - instead of licensing the intellectual property to the other party with the right to grant sublicenses - making the other party a sales agent performing services for a commission and have the license run directly from the licensor to the next level in the channel.
- *Practice Tip* - Licensee: Resist appointment as a sales agent, and insist instead on a license with rights to sublicense.
- *Practice Tip* - Licensee: Consider an outright acquisition of the intellectual property rather than a license. If the property interest is finally conveyed by the agreement, it is not executory. Negotiate for an exclusive rather than a non-exclusive license.

- G. **The 1988 Act.** The Lubrizol court, having found the license agreement to be an executory contract, allowed the trustee for the debtor/licensor to reject it, leaving Lubrizol with only a damages claim and no right to continue to practice under Richmond's patent for a metal coating process. The court observed that its holding would have a "general chilling effect upon the willingness of such parties to contract at all with businesses in possible financial difficulty." The business community took up this concern with a fervor, and in short order Congress passed an act<sup>25</sup> (the "1988 Act") amending Section 365 by adding new Section 365(n).

## IV. Licensor as Debtor

### A. Section 365(n).

1. *Scope.* Section 365(n) applies only to rejection of an executory contract by a debtor/licensor, not where the rejecting debtor is the licensee. (Rejection of an executory license agreement by a debtor/licensee continues to be governed by the other provisions of Section 365 and is discussed in part III of this article.)

- 
2. *Effect of 365(n)*. Section 365(n) addresses the rights and duties of the debtor/licensor and nondebtor/licensee under an intellectual property license both during the period prior to the debtor/licensor's assumption or rejection of the contract and after rejection.
- a. *Before Assumption or Rejection*. Unless and until the debtor/licensor rejects an executory license agreement, if the licensee makes a written request, Section 365(n) imposes certain obligations on the debtor/licensor.<sup>26</sup> It must:
- i. if provided in the agreement or in any agreement supplementary to it, either:
- (a) perform its obligations under the agreement, or
- (b) provide any of the licensed intellectual property "held by the trustee" (including any embodiment of the intellectual property "to the extent protected by applicable nonbankruptcy law") to the licensee; and it must:
- (c) not interfere with the rights of the licensee under the agreement, or any agreement supplementary to it, to the intellectual property, including any right to obtain the intellectual property from another party (such as an escrow agent).
- b. *After Rejection*. If the debtor/licensor rejects the agreement, the licensee may elect either (i) to treat the agreement as terminated, or (ii) to retain its rights under the agreement.
- i. *Treat as Terminated*. The licensee may elect to treat the agreement as terminated if the rejection by the debtor/licensor "amounts to such a breach as would entitle the licensee to treat such contract as terminated by virtue of its own terms, applicable nonbankruptcy law, or an agreement made by the licensee with another entity."<sup>27</sup> If the licensee does so, it may no longer practice under the license and is limited to an unsecured claim for damages for breach of contract.
- ii. *Retain Rights*. The licensee may instead elect to retain its rights under the license agreement and any supplementary agreement to the license agreement and any embodiment of the intellectual property for the term provided in the agreement and for any extension or renewal term to which the licensee may be entitled under applicable nonbankruptcy law. The retained rights include the right to enforce any exclusivity provision in the agreement, but exclude any other right to specific performance.
-

- iii. Consequences of Election to Retain. Section 365(n) spells out several significant consequences of an election by the licensee to retain its rights:
- (a) The licensee (i) must continue to pay all royalties (generally thought to include license fees<sup>28</sup>) due under the agreement during its term and any extension thereof to which the licensee is entitled, and (ii) will be deemed to have waived any right of setoff with respect to the agreement and any claim that it would have had under Bankruptcy Code Section 503(b) for administrative expenses.
    - *Practice Tip* - Licensee: Rather than provide that up-front payment will be applied (offset) against future license fee (royalty) obligations, provide, e.g., for 0% on first \$1 million, 5% on additional sales.
  - (b) The debtor/licensor, on the other hand, becomes obligated to (i) allow the licensee to exercise its rights, (ii) as before the rejection, provide any of the licensed intellectual property "held by the trustee" (including any embodiment of the intellectual property "to the extent protected by applicable nonbankruptcy law") to the licensee, and (iii) not interfere with the rights of the licensee under the agreement (or any agreement supplementary to it) to the intellectual property, including any right to obtain the intellectual property from another party such as an escrow agent.
3. "*Intellectual Property*." Section 365(n) does not define "intellectual property", but Bankruptcy Code Section 101(35A)<sup>29</sup> sets forth the following definition:
- (A) trade secret;
  - (B) invention, process, design, or plant protected under title 35;
  - (C) patent application;
  - (D) plant variety;
  - (E) work of authorship protected under title 17; or
  - (F) mask work protected under chapter 9 of title 17; to the extent protected by applicable nonbankruptcy law; and<sup>30</sup>

Note that the list does not include trademarks, trade names or service marks, or, by at least one reading of its literal terms, foreign patents and foreign copyrights.

- a. *Trademarks, Trade Names and Service Marks*. The legislative history of the 1988 Act makes clear that the omission of trademarks, trade names and service marks was intentional. As the Senate Judiciary Committee report states, "the bill does not address the rejection of executory trademark, trade name or service mark licenses by debtor-licensors....."

Since these matters could not be addressed without more extensive study, it was determined to postpone congressional action in this area and to allow the development of equitable treatment of this situation by bankruptcy courts."<sup>31</sup> At least part of the reason for Congress's unwillingness to extend the reach of the 1988 Act to trademarks was the fact that, unlike copyrights and patents, trademark owners must control the quality of the goods and services of their licensees in order to protect their rights in their marks. This ongoing quality control requirement is inconsistent with the remedy supplied by Section 365(n), which was designed to function without imposing executory obligations on the debtor/licensor.

- b. *Foreign Patents and Foreign Copyrights.* The statute is ambiguous as to whether foreign patents and copyrights are included in the Bankruptcy Code's general definition of intellectual property. The definition set forth in Bankruptcy Code Section 101(35A) lists an invention, process, design or plant "protected under title 35" and a work of authorship "protected under title 17". The quoted clauses can be read to mean either that the subject matter is intellectual property for Bankruptcy Code purposes if it qualifies for protection under those titles, whether of domestic or foreign origin, or that the subject matter must be of U.S. origin. No court has addressed this issue to date.
  4. *"Embodiments" and "Supplementary Agreements".* These terms are also not defined in the Bankruptcy Code. "Embodiments" of the intellectual property is generally understood to include source code, documentation and any other tangible form in which the intellectual property may be cast or explained. An "agreement supplementary to" a license agreement is generally understood to mean escrow agreements, but may not necessarily be so limited.
  5. *Improvements, New Releases, New Products.* Under Section 365(n), the rights retained by the licensee are retained "as such rights existed immediately before the [bankruptcy] case commenced."<sup>32</sup> Several commentators and at least one case<sup>33</sup> interpret this language to refer to the state of the intellectual property, rather than the state of the rights, on the petition date. By this interpretation, a retaining licensee would have no right to improvements to the technology, to new products to which it was entitled under the agreement, or to new releases of existing products. Whether the statutory language is ultimately deemed to refer to the state of the intellectual property or the state of the licensee's rights on the petition date, a rejected and retaining licensee will clearly not be able to force its debtor/licensor to create new intellectual property. However, several questions have not been addressed at all: (a) if the agreement allows, may the licensee continue work which improves the licensed intellectual property? (b) if the debtor/licensor voluntarily does so post-petition, may the licensee compel delivery of the resulting improvements or new products?
-

- *Practice Tip* - Licensee: Provide that licensee may improve the intellectual property, either unconditionally if negotiable, or in the event of licensor's failure to fulfill its obligations to do so; may be put in escrow agreement.
- B. **Trademarks.** Despite the invitation in the legislative history of the 1988 Act, only one court has suggested, in dictum, that trademarks are intellectual property within the meaning of Section 365(n).<sup>34</sup> Since no other courts have addressed the trademark issue of quality control, standard Section 365 analysis continues to be the rule regarding licensor rejection of trademark licenses.<sup>35</sup>

## V. Licensee as Debtor

- A. **Generally.** Where the debtor is a licensee, the licensor must be concerned with potential harm to its rights in the licensed intellectual property.
- B. **Rejection.** Although a debtor/licensee has the same right as a debtor/licensor under bankruptcy law to reject an executory contract, a rejecting debtor/licensee will not retain any rights to use the licensed intellectual property. Therefore, the only reason for a debtor/licensee to reject would be to escape burdensome terms.
- C. **Non-Assignable Contracts.** Contrary to the general rule of Section 365(a) regarding assumption of contracts in bankruptcy, under Section 365(c), a debtor/licensee may not assume or assign an executory contract if applicable non-bankruptcy law excuses the nondebtor from accepting performance from, or rendering performance to, an entity other than the debtor, without regard to whether the contract actually prohibits assignment.<sup>36</sup> Patent law and copyright law constitute "applicable non-bankruptcy law" for purposes of Section 365(c). It is generally settled under applicable patent and copyright law that a non-exclusive license is personal to the licensee and therefore not assignable without the consent of the licensor.<sup>37</sup> Accordingly, under Section 365(c), the debtor may not assume or assign a non-exclusive patent or copyright license.<sup>38</sup>
- *Practice Tip* - Licensor: Provide that license is automatically terminated upon an acquisition or change in control of licensee.
  - *Practice Tip* - Licensor: Avoid "exclusive" licenses, if feasible.
  - *Practice Tip* - Licensee: Negotiate for an exclusive rather than a non-exclusive license.
- D. **Trademarks.** The nondebtor/licensor must continue to perform under a license agreement but is prevented by the automatic stay from taking action to enforce the agreement against the debtor/licensee without going through the bankruptcy court.<sup>39</sup> However, the priorities of bankruptcy courts are guided by the goals of bankruptcy, not of trademark law, and so a trademark licensor cannot be confident that normal enforcement initiatives will be countenanced by the court. Moreover, the debtor/licensee may assume and assign the rights under the trademark license. As a result, a trademark licensor may find it difficult or impossible to adequately control the quality of the debtor/licensee's goods and services, and its rights in its mark may therefore be at risk.

- *Practice Tip* - Licensor: Given this prospect, a trademark licensor's best hope of avoiding damage to its marks in bankruptcy may be to accomplish a complete termination of the debtor/licensee's license rights prior to the bankruptcy filing by means of default or other termination provisions in the license agreement. To do so effectively will likely require active monitoring of the licensee's financial condition.

## VI. Security Interests In Intellectual Property

Although often of critical importance in determining the priority of a creditor's claims in bankruptcy proceedings, the creation, attachment and perfection of security interests in the various types of intellectual property is beyond the scope of this article. Suffice it to say that, in general, in order to ensure protection both against rival lien creditors and a trustee in bankruptcy (or debtor in possession), on the one hand, and against a subsequent transferee or purchase, on the other hand, "the careful lawyer will . . . file everywhere it is possible to do so with respect to a patent, trademark or copyright."<sup>40</sup> For an excellent treatment of this complex and unsettled area, see S. Montgomery, *Security Interests in Intellectual Property*, pp. 29-55 of Boston Bar Association course handbook for the April 6, 2001 continuing legal education seminar entitled *Intellectual Property and Bankruptcy: Strange Bedfellows for the New Millenium*.

## VII. Non-Bankruptcy Insolvency of License Parties

A financially distressed company may, of course, seek to manage its difficulties without resorting to the bankruptcy system. A variety of reorganization techniques are available that rely upon state law. In these situations, if the relationship has been structured with an eye to protection against the special risks of bankruptcy, the non-distressed party will, as a practical matter, be in substantially as good a position as it can be to deal with a so-called non-bankruptcy bankruptcy. Accordingly, this article does not discuss these situations further.

## VIII. Practice Tips

- A. **General.** In considering the actions a business may take to protect itself in dealing with a licensor or licensee of intellectual property that is financially shaky, business lawyers would do well to keep always in mind the point of the whole exercise: to make sales and collect the related receivables without exposing the business to undue risk.

In order to be an effective counselor - which often means being an effective mediator of the legally possible, the realistically available, and the absolutely necessary, balancing the bottom-line need to close sales and the equally bottom-line need to collect the money for those sales - the lawyer counseling a client in a real-world license negotiation must listen to both voices in the omnipresent (if unspoken) dialogue between the always "get-it-closed" VP Sales and the best-of-breed CFO. They may serve the same supreme deity in business, but their minor deities are different and opposed.

Much of what is written in this area contains drafting and/or Practice Tips. Many of those are included here (leaving out those that the author could not make sense of), together

---

with some suggestions that the author has not seen elsewhere. Virtually all of the tips presented here may be appropriate in a particular situation, but inappropriate and wildly unrealistic in the ordinary transaction.

Many of the possible ways of protecting one's client from the possible bankruptcy of the other party will be objectionable to the other party, so the drafting attorney should not employ them routinely or with the expectation that they will be easily accepted. At the end of the day, each party must balance the hoped-for benefits of the transaction against the risks, and ultimately may have to decide that the achievable risk/benefit balance is not acceptable.

## B. Pre-License Steps.

1. *Licensor Due Diligence.* A licensor should (but we all know they often do not) routinely evaluate the creditworthiness of its prospective licensees by requiring the submission of relevant financial information and investigating the prospect's financial soundness. If the financial due diligence reveals a business that is financially unsound, the licensor has available to it at this stage of the relationship all of the traditional tools for bolstering the security of its payment expectations from its licensee, including payment in advance, termination rights for nonpayment, and guarantees or letters of credit.
2. *Licensee Due Diligence.* A licensee should also evaluate the financial soundness of its prospective licensors, and particularly of vendors of strategically important intellectual property. Moreover, if the investigation reveals a financially shaky business, the licensee should consider whether the protections afforded by Section 365(n) would be adequate, where they apply, and in the case of a trademark license, what the effect would be on the licensee of a rejection in bankruptcy. If the investigation suggests that the licensor might be unable to fulfill its obligations, the licensee should consider a technology escrow arrangement, an outright purchase of the intellectual property, or even an acquisition of the vendor.

## C. Drafting Options.

1. *Both Parties.*
  - a. Consider a provision requiring the decision on assumption/rejection in bankruptcy to be made within specified time after filing.
2. *For Licensor (to Protect Against Future Bankruptcy of Licensee).*
  - a. Make late payment a default or breach, and make termination a remedy for material or repeated payment breaches.
  - b. Consider making deterioration in the financial condition of the licensee a default or breach, and make termination a remedy.

- 
- c. Consider "going dark" bans, i.e., make cessation or substantial reduction of normal business operations a breach.
  - d. In "channel" relationships, where the other party is not the end user but a reseller or other intermediary, consider - instead of licensing the intellectual property to the other party with the right to grant sublicenses - making the other party a sales agent performing services for a commission and have the license run directly from the licensor to the next level in the channel.
  - e. Avoid "exclusive" licenses, if feasible.
  - f. If an exclusive license is necessary, consider taking and perfecting a security interest in the licensee's property interest created thereby and its proceeds.
  - g. Even if a license agreement has some attributes of exclusivity, have both parties acknowledge that the agreement is executory and specify the continuing obligations on each side that make it so.
  - h. Include an ipso facto clause in agreements, even if it may be held not to be enforceable.
  - i. Provide that, pursuant to Bankruptcy Code 365(c)(1), agreement is not assignable by licensee without consent; recite facts to show reliance on particular licensee.
  - j. Provide that, pursuant to Bankruptcy Code 365(c)(1), agreement is not assumable in bankruptcy without consent; recite facts to show reliance on particular licensee.
  - k. Consider provisions that would cause termination upon an acquisition or change in control of licensee: outright prohibition, limited on permitted license volume, departure of key person(s).
  - l. Provide for shorter rather than longer terms - either by automatic termination unless mutually agreed renewals, or by automatic renewal subject to notice of nonrenewal, although former may be preferable in bankruptcy.

3. *For Licensee (to Protect Against Future Bankruptcy of Licensor).*

- a. Consider an outright acquisition of the intellectual property rather than a license.
  - b. Negotiate for an exclusive rather than a non-exclusive license.
  - c. Resist appointment as a sales agent, and insist instead on a license with rights to sublicense.
  - d. If the licensee does not obtain physical possession of the source code or other physical embodiments of the intellectual property, use an escrow agreement to ensure the licensee's access to the intellectual property embodiments.
  - e. Consider obtaining a lien on the underlying intellectual property and perfect in the manner appropriate to the type of intellectual property involved.
-

- f. For patent, copyright and trade secret licenses, specify that the agreement (and any related escrow agreement) is subject to Section 365(n).
- g. For patent, copyright and trade secret licenses, define any "embodiments" of the intellectual property and ensure possession of or access to physical embodiments.
- h. For trademark licenses, recite that the licensed subject matter is intellectual property and set forth the equivalent of the Lubrizol analysis that prompted enactment of Section 365(n) as justification for a provision allowing licensee to retain rights.
- i. Rather than provide that up-front payment will be applied (offset) against future license fee (royalty) obligations, provide, e.g., for 0% on first \$1 million, 5% on additional sales.
- j. Provide that licensee may improve the intellectual property, either unconditionally if negotiable, or in the event of licensor's failure to fulfill its obligations to do so; may be put in escrow agreement.
- k. Consider the use of a special purpose, bankruptcy-remote entity as a "buffer" licensee to hold the intellectual property.
- l. Clearly distinguish payments for the intellectual property ("royalty" payments in the language of the Bankruptcy Code) from payments for services or other benefits from which the licensor will be excused. For example, it is common for intellectual property license agreements to require the licensor to provide training to the licensee's personnel, to provide marketing, maintenance, technical support and warranty services, and to defend against infringement claims.
- m. Give licensee right to prosecute infringers and defend infringement claims if debtor/licensor fails to do so.
- n. Consider specifying what constitutes "adequate assurance of future performance" as a condition to assumption or assignment by the debtor/licensor. Possible elements of future performance that might be covered could include, for example, affirmative assumption by the assignee of the debtor/licensor's obligations and the financial and technical capability of performing them; minimum net worth or capital requirements necessary to perform such obligations; and not being a competitor of the licensee.

#### **D. Post-Signing and Pre-Petition.**

1. *Licensor's Options (to Protect Against Future Bankruptcy of Licensee).*
  - a. At the first signs of financial distress of a licensee, raise the level of oversight and stay on top of the situation.
  - b. Become more aggressive in demanding on-time payment and exercising termination rights if available before the licensee can file. You can still do business with the licensee but on different terms that put you in a more favorable position if bankruptcy results.

- c. At least talk to, and consider retaining, bankruptcy counsel. They have done this countless times and can help you assess your available courses of action and the likely responses by your licensee, who is probably already speaking with bankruptcy counsel.

2. *Licensee's Options (to Protect Against Future Bankruptcy of Licensor).*

**E. Post-Petition.**

1. *Both Parties.*

- a. *Bankruptcy Notices.* Pay attention to them. There are critical deadlines in bankruptcy proceedings. Make sure there is an internal procedure in place - and followed - for forwarding bankruptcy and other legal notices to the company's general counsel, whether in-house or outside.
- b. *Completion of Performance:* Review the remaining obligations under executory agreements to determine whether avoidance of executoriness by completing performance is feasible and desirable.

2. *Licensor's Options (to Deal with Bankruptcy of Licensee).*

- a. *Substantive Bankruptcy Advocacy.* Retain bankruptcy counsel. A licensor who moves aggressively may be able to affect the timing of payments it receives during the bankruptcy, negotiate with the debtor to reject the license, or persuade the debtor to assume the license, thereby turning all future claims for breach into administrative expenses in the bankruptcy case and entitling the licensor to payment ahead of most other creditors.

3. *Licensee's Options (to Deal with Bankruptcy of Licensor).*

- a. *Substantive Bankruptcy Advocacy.* Retain bankruptcy counsel. Contest determinations of non-assignability. Respond with appropriate notices under Section 365(n).

## Endnotes

---

<sup>1</sup> U.S. Bankruptcy Code, 11 U.S.C. (hereinafter "BC") 301.

<sup>2</sup> In Chapter 11 cases, unless the court rules otherwise, the debtor will be "in possession," i.e., it will continue to operate the business during the reorganization attempt. Although much of what is discussed in this article is also applicable to Chapter 7 cases, which are overseen by a court-appointed trustee, because a debtor in possession has, in general, all of the rights of a bankruptcy trustee under Bankruptcy Code Section 1107, the term "debtor" will be used hereinafter to refer to both the bankruptcy trustee and the debtor in possession.

<sup>3</sup> BC 541.

<sup>4</sup> See, e.g., *In re AGI Software, Inc.*, 199 B.R. 850 (Bankr. D. N.D. 1995); *In re Texascan Corp.*, 107 B.R. 227 (9th Cir. BAP 1989).

<sup>5</sup> BC 362.

<sup>6</sup> BC 363.

---

- 
- <sup>7</sup> See *In re Stein and Day, Inc.*, 81 B.R. 263 (Bankr. S.D.N.Y. 1988); *In re Learning Publications, Inc.*, 94 B.R. 763, 765 (Bankr. M.D. Fla. 1988); *In re AEG Acquisition Corp.*, 127 B.R. 34 (Bankr. C.D. Cal. 1991), *aff'd* 161 B.R. 50 (Bankr. 9th Cir. 1993).
- <sup>8</sup> See *In re Access Beyond Technologies, Inc.*, 237 B.R. 32, 44 (Bankr. D. Del. 1999).
- <sup>9</sup> BC 363(b)(1).
- <sup>10</sup> *N.L.R.B. v. Bildisco and Bildisco*, 465 U.S. 513, 104 S. Ct. 1188, at 1198, 79 L. Ed. 2d. 482 (1984).
- <sup>11</sup> *In re Qintex Entertainment, Inc.*, 950 F.2d 1492, 1495 (9th Cir. 1991).
- <sup>12</sup> BC 365(a).
- <sup>13</sup> BC 365(f)(1).
- <sup>14</sup> BC 365(b)(1).
- <sup>15</sup> BC 365(g).
- <sup>16</sup> BC 365(f)(2).
- <sup>17</sup> Vern Countryman, *Executory Contracts in Bankruptcy (Part I)*, 57 Minn. L. Rev. 439, 460 (1973), quoted in *Gloria Mfg. Corp. v. International Ladies' Garment Workers' Union*, 734 F.2d 1020, 1022 (4th Cir. 1984).
- <sup>18</sup> See, e.g., *In re Government Securities Corporation*, 101 B.R. 343, 349 (Bankr. S.D. Fla. 1989), *aff'd* 972 F.2d 328 (11th Cir. 1992).
- <sup>19</sup> See, e.g., *In re Blackstone Potato Chip Co., Inc.*, 109 B.R. 557, 560 (Bankr. D.R.I.1990); *In re Chipwich, Inc.*, 54 B.R. 427 (Bankr. S.D.N.Y. 1985).
- <sup>20</sup> *In re AEG Acquisition Corp.*, 161 B.R. 50, 59 (9th Cir. BAP 1993); *In re Learning Publications, Inc.*, 94 B.R. 763 (Bankr. M.D. Fla. 1988); *In re Stein and Day, Inc.*, 81 B.R. 263 (Bankr. S.D.N.Y. 1988).
- <sup>21</sup> See, e.g., *In re Learning Publications, Inc.*, 94 B.R. 763.
- <sup>22</sup> 625 F.2d 290, 292 (9th Cir. 1980).
- <sup>23</sup> See, e.g., *In re Szombathy*, 1986 Bankr. LEXIS 888, slip.op. at 21 (Bankr. N.D. Ill. 1996, rev'd on other grounds, 1997 U.S. Dist. LEXIS 5168 (N.D. Ill. 1997).; *Lubrizol Enterprises*, 756 F.2d 1043; *In re Biopolymers, Inc.*, 136 B.R. 28 (D. Conn. 1992).
- <sup>24</sup> 756 F.2d 1043 (4th Cir. 1985), *cert. denied*, 475 U.S. 1057 (1986).
- <sup>25</sup> Intellectual Property Bankruptcy Protection Act, Pub. L. No. 100-506, 102 Stat. 2538 (1988).
- <sup>26</sup> BC 365(n)(4).
- <sup>27</sup> BC 365(n)(1)(A).
- <sup>28</sup> *In re Prize Frize, Inc.*, 150 B.R. 456, 459 (Bankr. 9th Cir. 1993).
- <sup>29</sup> BC 101(35A).
- <sup>30</sup> *Sic* in original.
- <sup>31</sup> *Intellectual Property Licenses in Bankruptcy*, Senate Report (Judiciary Committee) No. 100-505, 100th Cong., 2nd Sess.
- <sup>32</sup> *Id.*
- <sup>33</sup> *Szombathy*, *supra*, note 23. *But see In re Storm Technology, Inc.*, 2001 B.R. Lexis 288 (Bankr. N.D. Ca. 2001) (applying only the statute's literal holding by holding that a springing license arising only upon default was not protected by Section 365(n) where no default preceded bankruptcy).
- <sup>34</sup> *In re Matusalem*, 158 B.R. 514 (Bankr. S.D. Fla. 1993).
- <sup>35</sup> See, e.g., *In re Gucci*, 126 F.3d 380, 394 (2d Cir. 1997); *In re Blackstone Potato Chip Co.*, 109 B.R. 557 (Bankr. D.R.I. 1990).
- <sup>36</sup> BC 365(c).
- <sup>37</sup> *In re James Cable Partners, L.P.*, 27 F.3d 534 (11th Cir. 1994); *In re Catapult Entertainment, Inc.*, 165 F.3d 747 (9th Cir. 1999) *In re CFLC, Inc.*, 89 F.3d 673 (9th Cir. 1996) and cases cited therein. These courts construed Section 365(c)(2) to prohibit assumption of a patent or copyright license by the debtor if assignment would be prohibited by "applicable non-bankruptcy law" and held that federal patent and copyright law prohibit assignment by a non-exclusive licensee and that, therefore, assumption by the debtor was prohibited. *Cf. Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1997), *cert. denied*, 117 S. Ct. 2511 (1997).
- <sup>38</sup> See, e.g., *In re Catapult Entertainment, Inc.*, 165 F.3d 747, 750 (9th Cir. 1999); *Harris v. Emus Records*, 734 F.2d 1329 (9th Cir. 1984); *but see matter of Sentry Data, Inc.*, 87 B.R. 943 (Bankr. N.D. Ill. 1988)
- <sup>39</sup> See, e.g., *Health Industries, inc. v. European Health Spas*, 489 F. Supp 860 (D.S.D. 1980)
- <sup>40</sup> 4 J. White and R. Summers *Uniform Commercial Code*, 30-12 at p. 87 (4th Ed. 1995).
-



---

**References:****Statutes**

U.S. Bankruptcy Code (11 U.S.C. 101 et seq.)

101(35A) Definition of intellectual property

105 Power of court

301 Voluntary Cases

362 Automatic stay

363 Use, sale, or lease of property

365 Executory contracts and unexpired leases

541 Property of the Estate

547 Preferences

548 Fraudulent transfers and obligations

**Legislative History**

*Intellectual Property Licenses in Bankruptcy*, Senate Report (Judiciary Committee) No. 100-505, 100th Cong., 2nd Sess.

**Law Review and Journal Articles**

Bartlett, *Effects of Bankruptcy on Licensing Under 11 U.S.C. 365(n)*, 5:7 J. Proprietary Rights 20 (July 1993).

Brinson, *Software Distribution Agreements & Bankruptcy: The Licensor's Perspective*, 64 Wash. L. Rev. 499 (July 1989).

Brown, Hansen and Salerno, *Technology Licenses Under Section 365(n) of the Bankruptcy Code: The Protections Afforded the Technology User*, 95:2 Comm. L.J. 170 (1990).

Chertok, *Structuring License Agreements with Companies in Financial Difficulty: Section 365(n) - Divining Rod or Obstacle Course?*, 65 St. John's L. Rev. 1045 (1991).

DeMeo, *License Agreement in Bankruptcy*, March 1999 les Nouvelles 21.

Feldman, *Bankruptcy and Software Licenses: Some Proposed Drafting Solutions*, 4:5 Computer Lawyer 13 (May 1987).

Fischer and Slater, *Bankruptcy and Tax Issues Affecting Licensing*, Paper presented at American Intellectual Property Law Association 1996 Spring Meeting, Boston, May 1-3, 1996.

Friedman and Wingens, *Averting Disaster When a Software Supplier Goes Bankrupt*, 8:2 Computer Law. 13 (Feb. 1991).

Gres, Note, *Software Agreements in Bankruptcy*, 8:361 Cardozo L. Rev. 361 (1986).

---

Guy and Youngman, *Understanding the Implications of a Licensor's and a Licensee's Bankruptcy*, 8 No. 2 *Intell. Prop. Strategist* 1 (Nov. 2001).

Jones and Pantaleo, *An Overview of Intellectual Property Licenses and Bankruptcy*, 827 *PLI/Comm* 129 (Bankruptcy Law & Practice Update: New Developments in an Uncertain Economy, Oct. 25, 2001).

Kaufman, *Technology Transfers and Insolvency - Some Practical Considerations*, 17 No. 1 *Computer Law*. 21 (Sept. 1993).

Kiekhofer and Selman, *Bankruptcy and Licensing*, 652 *PLI/Pat* 279 (Patent and High Technology Licensing 2001).

Kupetz, *Beware When Dealing with Licensors of Intellectual Property: Avoiding Potential Pitfalls Facing Licensees and Lenders When Bankruptcy Intervenes*, 17 No. 1 *Computer Law*. 21 (Jan. 2000).

Lieb, *The Interrelationship of Trademark Law and Bankruptcy Law*, 64 *Am. Bankr. L.J.* 1 (Winter 1990).

Livingston and Clark, *Technology Transfers: What if the Other Party Files Bankruptcy?*, *St. Mary's L.J.* 173 (1989).

Montgomery, *Security Interests in Intellectual Property*, pp. 29-55 of Boston Bar Association course handbook for April 6, 2001 continuing legal education seminar entitled Intellectual Property and Bankruptcy: Strange Bedfellows for the New Millennium.

Morris and Jensen, *Protection of Intellectual Property Rights Against Bankruptcy*, Nov. 1998 *JPTOS* 781.

Moskowitz, *Intellectual Property Licenses in Bankruptcy: New "Veto Power" for Licensees Under Section 365(n)*, 44 *The Business Lawyer* 771 (May 1989).

Moy, *The Intellectual Property Bankruptcy Protection Act: An Unbalanced Solution to the International Software Licensing Dilemma*, 11:1 *U. Pa. J. Int'l Bus. L.* 151.

Riback, *Intellectual Property Licenses: The Impact of Bankruptcy*, 672 *PLI/Pat* 201 (Understanding the Intellectual Property License 2001).

Tamiatti, *Technology Licenses Under the Bankruptcy Code: A Licensee's Mine Field*, 62 *Am. Bankr. L.J.* 295 (Fall 1988).

### **General Articles**

Gloster, *Bankruptcy and Technology*, *The Recorder*, p. 10, April 29, 1992.

Goldberg, *Treatment of Intellectual Property Licenses Under the Bankruptcy Code*, July/Aug. 1993 *Comm. L. Bull.* 20.

Riback, *Are Trademarks Intellectual Property In Bankruptcy? Maybe*, *NY L. J.*, September 7, 1994.

Rankin, *What Happens to a License for Intellectual Property When One Party to the Agreement Files for Bankruptcy? The Answer Depends on the Court Involved*, *National L.J.*, April 22, 1996.

---

---

*Ninth Circuit Slams Shut the "Back Door" Access to Patented Technology*, 18 Apr. 1999 A. Bankr. Inst. J. 18.

**Miscellaneous**

*Debtor as Licensor of Intellectual Property*, 365.14 Collier on Bankruptcy

*Licensing Rights to Intellectual Property*, Norton Bankr. L. and Prac. 2nd, 39:57.