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Commentary

HERE TODAY AND GONE TOMORROW: SECTION 365 AND THE UNFORTUNATE INTELLECTUAL
PROPERTY LICENSEE

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An intellectual property licensor's bankruptcy case poses a very real danger to its licensees. In many cases, licensed technology is necessary to the licensee's business operations and not readily available from other sources. For example, an Internet company may rely on licenses with content providers to obtain necessary content for its Web site. It probably also licenses key software necessary to operation of its Web site

Allowing any of these licensors to use [Section 365 of the Bankruptcy Code](#) to legally breach the terms of its license with the licensee and leave the latter with only a monetary claim as a remedy places a great burden on the licensee. This article discusses how the Bankruptcy Code attempts, and partly fails, to address the problem in its [Section 365\(n\)](#).

The problem was illustrated in 1986 by the U.S. Court of Appeals for the 4th Circuit's decision in *Lubrizol Enterprises Inc. v. Richmond Metal Finishers*. [\[FN1\]](#) *Richmond Metal Finishers* granted *Lubrizol Enterprises* a non-exclusive license for the use of a metal coating process. *Richmond* then filed a Chapter 11 petition and sought to reject the license to "facilitate sale or licensing of the technology unhindered by restrictive provisions in the *Lubrizol* agreement."

Despite the apparent devastating impact this would have on *Lubrizol*, the Court of Appeals allowed the trustee to reject the contract. The court declined to look at the impact of the estate's decision on the non-debtor party in deciding whether to allow rejection. Instead, the court limited its inquiry to whether the debtor had exercised proper business judgment, an analysis that focused solely on the decision's impact on the bankruptcy estate.

In response to the decision, Congress enacted the Intellectual Property Licenses in Bankruptcy Act, codified at [11 U.S.C. § 365\(n\)](#). [Section 365\(n\)](#) is based on a previously enacted provision of the Bankruptcy Code, designed to protect real estate lessees when a real estate lessor rejects a commercial lease. [\[FN2\]](#)

[Section 365\(n\)](#) allows certain licensees to retain their rights in intellectual property, despite the licensor rejecting the license agreement. It applies only to executory contracts under which the debtor is a licensor of a right to intellectual property.

Under [Section 365\(n\)](#), if the licensor rejects its "intellectual property" license, the licensee has two options. First, the licensee can treat the contract as terminated. In that event it loses its ability to use the content provided under the license, but it does gain a general unsecured claim against the licensor for damages -- essentially the same treatment received for breach of a regular executory contract.

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Second, the licensee can elect to retain its rights under the license to the intellectual property as such rights existed immediately before the bankruptcy case. In that case, it can continue to use the licensed intellectual property.

The licensee does not retain all of its rights as described in the license, but a specific bundle of rights provided by the Bankruptcy Code. These rights include the right to enforce an exclusivity provision against the debtor and the right to continue to use the intellectual property for the term of the license. In return for these rights, the licensee must make royalty payments and waive certain rights of setoff and administrative claims.

Unfortunately, [Section 365\(n\)](#) provides only a partial solution. It excludes trademark licenses from its scope. It fails to provide licensees effective protection under today's complex licensing contracts. Finally, a recent decision suggests licensors can trump [Section 365\(n\)](#) by selling the intellectual property free and clear of the license.

The term "intellectual property" is specifically defined by [11 U.S.C. § 101\(35A\)](#). That definition does not include licenses for the use of a trademark. [\[FN3\]](#) Elimination of trademark rights from the bankruptcy definition of intellectual property presents a special problem for licensees of Web site content, who may be licensing both content or technology protected by copyright, patent or trade secret rights as well as the right to use the licensor's trademarks.

A real-life illustration is that of Yahoo!, which licenses content and technology from third parties and uses the licensors' trademarks to promote the Yahoo! Web site. [\[FN4\]](#) In that case, the license for the content or technology incorporates copyrights and trade secrets -- and thus [Section 365\(n\)](#) provides protection for those licenses, but the trademark license is not protected.

In the Centura Software Corp. [\[FN5\]](#) case, a software reseller discovered this weakness the hard way. Raima UK Limited held a license allowing it to resell Centura's software in the United Kingdom. The debtor rejected the relevant license agreement and Raima exercised its rights under [Section 365\(n\)](#) to retain its intellectual property license.

The U.S. Bankruptcy Court for the Northern District of California held that while Raima could continue to sell the software, it could not continue to do so using the debtor's trademarks. The right to continue to use the trademarks was not protected by [Section 365\(n\)](#).

Even where trademark rights are not central to the license, [Section 365\(n\)](#) still leaves the non-debtor licensee with substantial risk. The right it provides to continued use of "intellectual property" is useless under many circumstances.

For example, those rights might be limited by the filing of the bankruptcy petition. The intellectual property rights preserved by [Section 365\(n\)](#) are those existing when the debtor files its bankruptcy petition. Rights that arise after the bankruptcy petition are not protected. [\[FN6\]](#)

Such situations can occur in a number of contexts. First, a licensor or seller of intellectual property might require a license back that comes into being on some circumstance occurring, such as the other party's breach of the contract. Such mechanisms are sometimes used in lieu of taking a security interest in the asset.

A licensee may contract to receive a further license in improvements or derivative works created by the licensor. A licensor may require a license back of improvements from its licensee, a form of cross-license agreement. Some of these situations represent attempts to contract around various provisions of bankruptcy or commercial law.

In other cases, they represent a very real and important aspect of the deal. A software reseller or patent licensee may need access to new software versions and improvements to the technology in order to stay competitive. Rejection cuts off the right to use technology created post-petition, even if the license agreement grants the right to improvements. The licensee is stuck using or selling old technologies, while competitors, and perhaps the debtor itself, move forward in the marketplace.

A content licensee might require a continuous flow of new licensed content for its software or Web site. Mapping

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applications, directories and news feeds all require new content all the time. Imagine a news Web site that never updated its content. Similarly, the right to continue to use uncopyrightable data, like telephone numbers, is not protected.

Most license contracts today also contain a large number of cross-obligations that rest outside of the core intellectual property license. However, the licensee's ability to make use of the license usually depends on the licensor continuing to perform these obligations.

For example, many software licensees depend on the licensor to provide technical support and help maintain the software systems. The licensor's obligation to provide these services is eliminated on rejection. Unless the licensee can obtain these services elsewhere, the right to continue to use the software has limited use. [Section 365\(n\)](#) does nothing to address this issue.

Even the limited rights the licensee might retain under [Section 365\(n\)](#) might be stripped away by a sale of the related intellectual property. The Bankruptcy Code provision governing sales, [11 U.S.C. § 363](#), might cut off a licensee's ability to exercise rights under [Section 365\(n\)](#).

[Section 363\(f\)](#) allows a trustee to sell property of the bankruptcy estate free and clear of a third party's interest in the property. Theoretically, this provision could allow a debtor to sell its intellectual property to a third party free of a licensee's right to use the intellectual property, effectively eliminating the license.

Because this technique would not involve a rejection of the license, [Section 365](#) would not come into play and its provisions protecting licensees would be inapplicable. [Section 365\(n\)](#) clearly states that the licensee's right to elect to retain rights to use the intellectual property is available as an option if the trustee rejects the license.

In a parallel situation, the U.S. Court of Appeals for the 7th Circuit in *Precision Industries Inc. v. Qualitech Steel SBQ LLC* held that a sale of real estate under [11 U.S.C. § 363](#) could cut off special protections provided lessees of real estate by [11 U.S.C. § 365\(h\)](#). [\[FN7\]](#) [Section 365\(h\)](#) grants commercial real estate tenants special holdover rights when a debtor landlord rejects a real estate lease. This situation parallels that which an intellectual property licensee faces on rejection of a license, and [Section 363\(h\)](#)'s framework is quite similar to [Section 363\(n\)](#)'s.

In the *Qualitech* case, the debtor owned land subject to a 10-year lease. The debtor sold all of its assets, including the land, and the sale order transferred all of the debtor's assets to the buyer free and clear of all interests. The court held that the sale was clear of the tenant's leasehold interest and further held that the tenant could not take advantage of the protections provided by [Section 365\(h\)](#).

The court noted that not only is there no indication in the Bankruptcy Code that the debtor's right to sell free and clear under [Section 363\(f\)](#) is subordinate to [Section 363\(h\)](#), but that [Section 363\(h\)](#), by its language, applies only when the debtor rejects the lease.

The statutory interplay between [Sections 363\(f\)](#) and [365\(h\)](#) is identical to that between [Sections 363\(f\)](#) and [365\(n\)](#), meaning the reasoning in *Qualitech* could allow an intellectual property owner to sell its intellectual property "free and clear" of existing license rights. Thus, an intellectual property owner could effectively terminate a license without rejecting it. In fact, the 7th Circuit had applied this same reasoning, in dicta, in an earlier case addressing the effect of an asset sale on a purported copyright license. [\[FN8\]](#)

Because [Section 365\(n\)](#) provides potentially illusory relief, when a patent or copyright licensor files for bankruptcy, the licensee's first step should be to obtain qualified counsel to closely monitor the case and help it plan for a potential rejection. All is not lost. The attentive licensee has a large number of options to help it reduce risk.

The licensee should monitor sale motions and other activity that might affect it or provide clues to the debtor's future plans. The licensee needs to determine what the risks are to it if the debtor rejects the license, if the debtor stops providing services or information in accordance with the license or related agreements, if the debtor changes its business strategy with respect to the licensed technology, or if the debtor sells the intellectual property rights to a third party.

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The licensee might take immediate steps to address these risks. The licensee might try to acquire the technology from the debtor or at least start to make plans to buy the technology should the debtor try to sell it. The licensee might exercise its right to obtain a surrender of intellectual property assets or technology escrow.

The licensee might start making contingency plans to handle rejection of the license and, where the cost of uncertainty is high, consider asking the bankruptcy court to shorten the time for the debtor to make its decision. Finally, the licensee should be reviewing, timely, pleadings in the case for attempts by the debtor to reject the license, transfer the license or related intellectual property rights, or collateralize royalty payments.

When a licensor files bankruptcy, the licensee needs to closely monitor sale motions and the plan to make sure that the licensor is not selling its intellectual property rights free and clear of the license. The sale motion and proposed order do not have to explicitly target the license. The harmful clause might be as simple as "all assets free and clear of all claims, liens and interests." Where the language in a proposed sale is ambiguous and could potentially cut off the license, the licensee should object to the sale or at least seek a clarification of the sale order. The licensee ignores the sale's possible impact at its own peril.

The licensee that objects to a sale has several options available to it. First, [11 U.S.C. § 363\(f\)](#) only allows a debtor to sell intellectual property free and clear of license interests in four situations:

- When non-bankruptcy law permits the sale free and clear of the license; [\[FN9\]](#)
- When the licensee consents; [\[FN10\]](#)
- When the license is in bona fide dispute; or
- When the licensee could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of its rights under the license. [\[FN11\]](#)

Because none of these situations exist with respect to the typical intellectual property license, a licensor should have difficulty stripping intellectual property free of a license when the licensee appears and objects. Thus, the best way to avoid the Qualitech problem is to pay attention.

Second, when a trustee tries to sell property in which a third party has an interest, under [11 U.S.C. § 363\(e\)](#) the Bankruptcy Court must either prohibit or condition the sale as necessary to provide the third party with adequate protection of its interest. While exact application of this provision is uncertain in the context of protecting an intellectual property license, it should allow a licensee to suggest conditions for a sale free of its license. Most likely, the licensee would argue that the debtor be required to reject the license before selling the intellectual property, allowing the licensee to exercise the rights made available by [11 U.S.C. § 365\(n\)](#).

Where the relief [Section 365\(n\)](#) provides will prove inadequate, the licensee may have available some additional arguments or tactics, depending on the situation and the court.

The trustee's right to reject an executory contract is not absolute. [Section 365](#) requires Bankruptcy Court approval. The harsh result [Section 365](#) can produce is caused by application of the business judgment test to the court's evaluation of the trustee's decision. This test, which looks solely at the decision's impact on the estate, requires that the court allow rejection even when the non-debtor party will be greatly damaged as a result.

However, during the 1980s a number of courts applied a balancing test that allowed consideration of the trustee's decision on the non-debtor party to the contract. This more flexible test will not allow rejection where the non-debtor party would be damaged disproportionately to any benefit to be derived by the general creditors of the estate. [\[FN12\]](#) This balancing of equities, definitely a minority position, is disfavored and has seen little application since the 1980s.

However, a judicious application of the balancing test would provide a mechanism for avoiding unjust results through application of [11 U.S.C. § 365](#) and solve some of the problems that [Section 365](#) still creates in the area of intellectual property licensing. Courts now faced with new situations might look to the balancing test to solve the problems with [Section 365\(n\)](#). [\[FN13\]](#)

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In the Centura Software [\[FN14\]](#) case discussed above, the court held that a software reseller whose copyright license was rejected could continue to sell the software under [Section 365\(n\)](#) but could not use the debtor's trademarks when so doing. In dicta, the court noted that had the licensee objected to the debtor's motion to reject the license, the court might have been able to fashion a remedy for the problem or take into account the effect the license rejection would have on the licensee. In other words, the court signaled the possibility that it would consider the balancing test in a similar case in the future.

Finally, the licensee of a rejected license might be able to turn to state law remedies available based on the debtor's rejection. The debtor's rejection of the license is treated as a breach of the license as of immediately before the date of the bankruptcy filing. [\[FN15\]](#) This gives the licensee a pre-petition claim for damages for the breach and might allow application of other remedies for breach provided under the contract.

That pre-petition claim remains regardless of whether the licensee elects to continue to use the intellectual property under [Section 365\(n\)](#). Further, if the licensee decides to treat the license as terminated, it may be able to take advantage of further remedies.

In Independent American Real Estate, [\[FN16\]](#) the non-debtor party to a rejected real estate construction contract sought damages based on liquidated damages provisions in the contract. The court held that "state law specifies the remedies of a non-breaching party to a contract when the contract is breached, to the extent state law does not contravene the Bankruptcy Code."

Analyzing Texas state law regarding application of liquidated damages clauses, the court determined that the liquidated damages clause in the contract was enforceable and should be used in determining the amount of the licensee's rejection claim.

On the other hand, in EI International [\[FN17\]](#) the rejected contract had a liquidated damages clause that carefully spelled out the various categories of damages the licensee could seek if the licensor rejected the contract. The court held that the license, when rejected, was rejected in full and that meant the liquidated damages clause was rejected as well. The licensor's damage claim should be computed without regard for the liquidated damages clause. [\[FN18\]](#)

The rule that a bankruptcy court should look to state law to determine the remedies available to the licensee leaves open the possibility of injunctive relief, when no adequate remedy exists at law. [\[FN19\]](#) Specifically, the licensee might seek an order requiring specific performance under the contract. This remedy might be particularly appropriate to enforce secondary obligations that explicitly survive termination of the contract, such as confidentiality provisions.

In the context of a trademark license, the trademark licensee will not, however, be able to turn to specific performance to retain rights to use the mark. In the Centura Software [\[FN20\]](#) case, for example, the court considered this argument and held that specific performance was not available as a remedy for the trademark licensee. [\[FN21\]](#)

So, all is not lost for the poor abandoned intellectual property licensee. Debtors do need relief from unprofitable contractual relationships and [Section 365](#) provides a mechanism for that relief. That should not, however, give them leave to leave their old intellectual property licensees burning in their wake like so many Roman towns ransacked by rampaging barbarians. Solutions are there, they just require attentive counsel and a little creativity.

[\[FN1\]](#). [756 F.2d 1043 \(4th Cir. 1985\)](#), cert. denied, [475 U.S. 1057 \(1986\)](#).

[\[FN2\]](#). [11 U.S.C. § 365\(h\)\(1\)](#).

[\[FN3\]](#). [In re HQ Global Holdings Inc.](#), [290 B.R. 507, 512-513 \(Bankr. D. Del. 2003\)](#) (in the context of a rejected franchise agreement); [In re Centura Software Corp.](#), [281 B.R. 660 \(Bankr. N.D. Cal. 2002\)](#). Another case, [In re](#)

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[Matusalem, 158 B.R. 514 \(Bankr. S.D. Fla. 1993\)](#), has been looked to for the proposition that [11 U.S.C. § 365\(n\)](#) includes protection of trademark licenses. However, that case, which dealt with a franchisee's attempt to reject a franchise agreement containing patent, copyright and trademark licenses, discussed [Section 365\(n\)](#) in dicta and did not clearly indicate that [Section 365\(n\)](#) would protect the trademark license component of the franchise agreement.

[FN4]. For example, see <http://yp.yahoo.com>, which includes a yellow pages logo.

[FN5]. [281 B.R. 660 \(Bankr. N.D. Cal. 2002\)](#).

[FN6]. [In re Storm Tech., 260 B.R. 152 \(Bankr. N.D. Cal. 2001\)](#) (a license right arising on account of a payment default was not protected under [11 U.S.C. § 365\(n\)](#) when the payment default occurred post-petition).

[FN7]. [327 F.3d 537 \(7th Cir. 2003\)](#). For commentary critical of the Qualitech decision, see Martin J. Bienenstock, Recent Developments Affecting Chapter 11 Cases, 26th Annual Current [Developments in Bankruptcy & Reorganization](#), 862 PLI/Comm 337, 347 (April/May 2004); Michael Baxter, [Section 363 Sales Free and Clear of Interests: Why the Seventh Circuit Erred in Precision Industries v. Qualitech Steel](#), 59 *Bus. Lawyer* 475 (February 2004).

[FN8]. [FutureSource LLC v Reuters Ltd., 312 F.3d 281, 285 \(7th Cir. 2002\)](#).

[FN9]. Which, generally, applicable intellectual property laws do not allow. However, in cases where the license qualifies as an assignment of the intellectual property right, it is possible that the intellectual property could be sold free of the license when the assignment is not recorded.

[FN10]. A failure to object to the sale motion qualifies as a consent to the sale. [FutureSource LLC v. Reuters Ltd., 312 F.3d 281, 285 \(7th Cir. 2002\)](#), cert. denied, [123 S. Ct. 1769 \(2003\)](#).

[FN11]. Another situation which is not likely to exist with respect to most intellectual property licenses.

[FN12]. [In re Huang, 23 B.R. 798, 801-02 \(B.A.P. 9th Cir. 1982\)](#); [In re Meehan, 59 B.R. 380, 385 \(E.D.N.Y. 1986\)](#); [Infosystems Tech. Inc. v. Logical Software Inc., 1987 WL 13805, 2 \(D. Mass. 1987\)](#); [In re Midwest Polychem, 61 B.R. 559, 562 \(Bankr. N.D. Ill. 1986\)](#); [In re Chipwich Inc., 54 B.R. 427, 431 \(Bankr. S.D.N.Y. 1985\)](#); [In re Turbowind, 42 B.R. 579 \(Bankr. S.D. Cal. 1984\)](#); [In re Petur, 35 B.R. 561, 563-64 \(Bankr. W.D. Wash. 1983\)](#). A number of these decisions purported to apply the business judgment test but in fact applied a balancing test.

[FN13]. See [In re Centura Software Corp., 281 B.R. 660 \(Bankr. N.D. Cal. 2002\)](#); [In re Matusalem, 158 B.R. 514 \(Bankr. S.D. Fla. 1993\)](#).

[FN14]. [281 B.R. 660 \(Bankr. N.D. Cal. 2002\)](#).

[FN15]. [11 U.S.C. § 365\(g\)\(1\)](#).

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[FN16]. [146 B.R. 546 \(Bankr. N.D. Tex. 1992\).](#)

[FN17]. [123 B.R. 64 \(Bankr. D. Idaho 1991\).](#)

[FN18]. Similar results occurred in [In re TransAmerican Natural Gas Corp., 79 B.R. 663 \(S.D. Tex. 1987\)](#); [In re Hamilton Roe Int'l Inc., 162 B.R. 590 \(Bankr. M.D. Fla. 1993\).](#)

[FN19]. [In re West Chestnut Realty of Haverford Inc., 177 B.R. 501 \(Bankr. E.D. Pa. 1995\).](#)

[FN20]. [281 B.R. 660 \(Bankr. N.D. Cal. 2002\).](#)

[FN21]. See also [Lubrizol Enters. Inc. v. Richmond Metal Finishers Inc., 756 F.2d 1043 \(4th Cir. 1985\)](#), cert. denied, [475 U.S. 1057 \(1986\)](#); [In re HQ Global Holdings Inc., 290 B.R. 507, 513 \(Bankr. D. Del. 2003\)](#); [In re EI Int'l, 123 B.R. 64 \(Bankr. D. Idaho 1991\)](#); [In re Chipwich Inc., 54 B.R. 427 \(Bankr. S.D.N.Y. 1985\).](#)

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