With the continued growth of the software industry and other high-tech businesses, intellectual property issues arise frequently in bankruptcy cases. Bankruptcy law has a major potential impact on the enforceability of license agreements. Bankruptcy can dramatically affect both licensors and licensees of intellectual property. Problems arise in the context of the assumption, assignment, or rejection of intellectual property licenses under Section 365 of Title 11 of the United States Code (the “Bankruptcy Code”). This article outlines the general principles applicable to intellectual property licenses in bankruptcy and provides basic practice tips for licensors and licensees.

I. How does bankruptcy affect intellectual property licenses?

A. General Principles

1. Bankruptcy does not revive license agreements terminated prior to bankruptcy.

Bankruptcy has limited relevance to the pre-bankruptcy termination of a license. A trustee or debtor in possession has no ability to revive a contract effectively terminated under state law prior to bankruptcy. Debtors in possession and trustees must generally conduct business in compliance with non-bankruptcy laws, including intellectual property laws. The termination of a license prepetition precludes a licensee debtor (such as a debtor in possession or its trustee) from using any of the intellectual property post-petition. Similarly, a pre-petition termination by a licensor debtor also terminates all rights of the non-debtor licensee, and the non-debtor licensee is not entitled to any of the protections of Section 365(n) of the Bankruptcy Code, discussed infra.

There are at least two caveats. One is that state or other applicable non-bankruptcy law must be consulted to determine whether termination was actually effective. The other is that the termination of a right that has value to the bankruptcy estate may constitute a preferential transfer or fraudulent conveyance, which may be subject to avoidance by the bankruptcy court in an action by the debtor in possession or trustee.

Also, the grant of a license may be revoked by a debtor in possession or trustee using the “strong-arm” powers of Section 544, the preferential transfer provisions of Section 547 and the fraudulent transfer provisions of Section 548. Among other rights, the debtor in possession has whatever rights a hypothetical judicial lien creditor or an unsecured creditor would have to avoid transfers of property and recover them for the benefit of the estate.

2. Bankruptcy sets deadlines for a trustee or debtor in possession to decide how to proceed with respect to its intellectual property
licenses, to the extent they constitute executory contracts or unexpired leases.

In Chapter 7 liquidation cases, under Section 365(d)(1) of the Bankruptcy Code, a trustee must assume or reject an executory contract or unexpired lease within 60 days of the order for relief or the subject contract or lease is deemed rejected. The court may extend this time for cause.

In Chapter 11 cases, under Section 365(d)(2) of the Bankruptcy Code, a trustee or debtor in possession may assume or reject an executory contract or unexpired lease of personal property at any time before confirmation of a plan. However, the non-debtor party to the contract or lease may move the court to set an earlier time for assumption or rejection or to grant relief from the automatic stay to terminate the agreement; otherwise, the non-debtor party is required to continue to accept performance from the debtor.\(^7\)

3. The automatic stay prevents termination of a license during bankruptcy without bankruptcy court approval.

The automatic stay of Section 362(a) of the Bankruptcy Code precludes unilateral termination of a contract by a non-debtor party before its expiration. Courts have held this to be so even where the contract provides for “at-will” termination.\(^8\) Even if the debtor commits a post-petition breach, the non-debtor party must obtain relief from stay to terminate the contract.\(^9\)

4. The non-debtor party’s limited enforcement options and payment rights require bankruptcy court approval.

The debtor in possession or trustee, unlike the non-debtor party, may enforce a license in accordance with its terms, in the “limbo period” after the bankruptcy case filing but prior to assumption.\(^10\) A non-debtor party to a license may not enforce the license prior to its assumption and instead must move the bankruptcy court to set a time for assumption or rejection.\(^11\) The non-debtor party may also seek post-petition payments as an administrative expense priority claim to the extent of the value of the benefit provided to the debtor in possession or trustee during the bankruptcy.\(^12\) This value may be difficult to prove.\(^13\) Even if the debtor in possession or trustee uses goods provided under an executory contract, if the goods were delivered pre-petition, no “post-petition benefit” is conferred.\(^14\)

5. Insolvency or filing for bankruptcy alone is probably not a basis to terminate the license once bankruptcy begins.

Generally, a debtor in possession or trustee may assume or assign a contract or lease despite default provisions triggered by the debtor’s bankruptcy filing, its insolvency or poor financial condition, or the appointment of a trustee or custodian.\(^15\) Contract provisions that, although not specifically referring to a
debtor's financial condition, in effect create defaults inherent in a bankruptcy setting, may also be unenforceable. However, to the extent a license of intellectual property excuses the non-debtor party from accepting performance from or rendering performance to a party other than the debtor, these “ipso facto” provisions may also be enforceable if authorized by the bankruptcy court.

B. Practice Tips

1. Terminate the license prior to bankruptcy. If termination for insolvency is desired, clearly define insolvency-related defaults in the license agreement.
2. If there is any dispute, file a motion or other proceeding in the bankruptcy court to determine that the termination was effective pre-petition.
3. If termination of the license is desired after bankruptcy, file a motion to shorten the time for assumption or rejection of executory contracts under Section 365(d)(2), a motion for a determination that the license may not be assumed or assigned under Section 365(c)(1) or a motion for relief from the automatic stay under Section 362(d).
4. If payments by the trustee or debtor in possession are not being made after bankruptcy, file a request for allowance and payment of an administrative expense under Section 503(b)(1)(A) or to compel assumption of the license under Section 365(d)(2).
5. If actions by the trustee or debtor in possession are required to protect the non-debtor’s interests during the bankruptcy, file a motion for adequate protection.
6. Be vigilant during the case and object to sale motions, Chapter 11 plans or other actions by the trustee or debtor in possession to the extent they violate the non-debtor’s intellectual property rights.

II. Is a license an executory contract?

A. General Principles

Only contracts which are executory may be assumed, assigned, or rejected under Section 365 of the Bankruptcy Code. The Bankruptcy Code does not define “executory.” Bankruptcy courts most often cite the definition developed by Professor Vern Countryman for whether a contract is executory. Under the Countryman definition, a contract is executory where both the debtor and the non-debtor party have unperformed obligations such that failure of either to complete performance would constitute a material breach excusing the performance of the other.

As a general rule, non-exclusive licenses of intellectual property are considered executory contracts, whereas exclusive licenses are not. Whether sufficient
performance remains due on both sides for the contract to be executory is frequently a difficult question. Negative covenants have been determined to be sufficient to make a contract executory.\textsuperscript{20} Even the common license agreement provision prohibiting the parties from suing for infringement has been construed as sufficient for a license agreement to remain executory.\textsuperscript{21}

**B. Practice Tip**

It is extremely difficult for non-debtor licensees to prevent rejection based on lack of executory duties. However, see infra as to Section 365(n) protections for licensees.

**III. Can a license be assigned to a third party by a bankruptcy trustee or debtor in possession?**

**A. General Principles**

An executory contract must be assumed in order to be assigned under §365. Absent consent by non-debtor patent or copyright licensors, both assumption and assignment are prohibited in many circuits. Even in circuits where assumption may be permissible, assignment will be prohibited unless the licensor consents.

1. Anti-assignment provisions are unenforceable in run-of-the-mill executory contracts.

Assignment of a lease or contract relieves the bankruptcy estate of liability for any future breach.\textsuperscript{22} A trustee or debtor in possession may usually assign an executory contract or unexpired lease regardless of anti-assignment provisions.\textsuperscript{23} If anti-assignment provisions are to be overridden, the trustee or debtor in possession must first assume the contract or lease, including provision for cure of defaults, and, as discussed above, provide adequate assurance of performance by the assignee regardless of whether there had been a previous default.\textsuperscript{24} Courts have construed contract provisions as the equivalent of unenforceable anti-assignment clauses where the effect of the provision is to restrict assignment.\textsuperscript{25}

2. Licenses are inherently non-assignable without licensor consent.

A debtor in possession or trustee may not assign an executory contract if applicable law would excuse the non-debtor party from accepting performance or rendering performance to the trustee or assignee and the non-debtor party does not consent to assumption or assignment. This prohibition will generally include personal service contracts.\textsuperscript{26} Applicable non-bankruptcy law may also include government regulations barring assignment of particular contracts.\textsuperscript{27}

Inherent non-assignability is a major issue with intellectual property licenses. Courts have opined that contracts in which the debtor is licensee of a patent are
inherently non-assignable under federal common law absent the licensor’s consent.\textsuperscript{28} The Ninth Circuit reached the same conclusion for both copyright licenses and patent licenses.\textsuperscript{29} There have now been many cases addressing whether the licensee’s interest in a patent, copyright, or trademark license can be assigned. Some of those address whether exclusive as well as non-exclusive licenses are inherently non-assignable without consent.\textsuperscript{30} Federal common law holds that a trademark licensor’s consent is required to transfer or sublicense a trademark license, and thus, a trademark license is non-assignable in bankruptcy.\textsuperscript{31}

For debtors, trustees, and secured creditors, this “inherent non-assignability” is a major factor. As many high-tech and telecom bankruptcies involve liquidations, inherent non-assignability can be significant. Even liquidation of computer hardware can trigger an objection to transfer of software contained or included in the equipment.

However, although, hypothetically, a licensor may block assignment, that does not mean the licensor will not consent to assignment. Often, licenses contain conditional assignment rights that are much broader than the limited right to assign the license to affiliates or at the discretion of the licensor. Obtaining consent to assignment of the license is not only important for the licensee, but also for any secured lender relying on the existence of the license rights for its perceived collateral value.

\textbf{B. Practice Tips}

1. Be vigilant and object to the motion to assign the license or to a Chapter 11 plan providing for such an assignment.

2. Define in the license agreement what constitutes adequate assurance of future performance, such as net worth or capital requirements, performance benchmarks, non-compete clauses, and scope limitations. Provisions must be applicable to the original licensee as well as any permitted assignee.

\textbf{IV. Can an intellectual property license ever be assumed by a bankruptcy trustee or debtor in possession without consent? (The “Catapult” Problem)}

\textbf{A. General Principles}

Where the debtor licensee would like to continue to use the intellectual property in its own business, the licensee will seek to assume the license. In the majority of federal circuits, where assignment is prohibited without the consent of the licensor, the debtor in possession or trustee will be precluded from assuming the license, even though no assignment is contemplated.
Because of the presumption that a Chapter 11 debtor will reorganize and retain its assets, the mere filing of a Chapter 11 case alone arguably does not implicate the federal policy of “inherent non-assignability” of patent or copyright licenses, regardless of theoretical arguments that the bankruptcy filing creates a transfer to the bankruptcy estate. Generally, the creation of a bankruptcy estate does not of itself create a transfer to the trustee or debtor in possession, triggering anti-assignment concerns. However, 11 U.S.C. § 365(c) provides:

(c) The trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if—

(1)(A) 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 or the debtor in possession whether or not such contract, or lease, prohibits or restricts assignment of rights or delegation of duties; and

(B) such party does not consent to such assumption or assignment; . . . .

A literal reading of the statute leads to the so-called “hypothetical” test, which holds that if an executory contract may not be assigned to a third party under applicable non-bankruptcy law, then it cannot even be assumed by the trustee or debtor-in-possession for use by the reorganized debtor post-bankruptcy. It requires courts to decide whether, under applicable law, assignment to a third party would be forbidden. A less literal reading of the statute has led some courts to look to whether actual assignment will occur (the “actual” test).

Until the split in the circuits regarding non-assumability of inherently non-assignable contracts is resolved by Congress or the U.S. Supreme Court, absent consent of the licensor, a Chapter 11 debtor in at least the Third, Fourth, Ninth, and Eleventh Circuits may not assume a copyright or patent license in which the debtor is licensee. The First and Fifth Circuits, on the other hand, follow the “actual” test. At least one bankruptcy judge in the Southern District of New York also follows the “actual” test, where the debtor in possession has no intent to assign the license.

Two factors are important in avoiding the potentially harsh effects of Section 365(c)(1). First, consent by the licensor avoids the problem. If the licensor has conditionally consented to assignment in the license itself, the license should be assumable and assignable, subject to satisfying the assignment conditions. Secondly, although Section 365(c)(1) may prohibit assumption or assignment without the licensor’s consent, it does not compel rejection at any specific date. This allows the estate to utilize the license during the potentially lengthy limbo period, unless the licensor can convince the court that rejection should be
compelled early.\textsuperscript{34}

It is important to note, however, that the Bankruptcy Court for the District of Delaware, at least, has held that the Catapult problem (see footnote 32) cannot be avoided by attempting to sell the license without assumption, because until assumed, an executory contract is not an asset of the estate and cannot be sold.\textsuperscript{35}

Even if the debtor in possession or trustee is able to overcome the restrictions of Section 365(c)(1) of the Bankruptcy Code, it still may not assume the license unless the bankruptcy estate provides cure or adequate assurance of prompt cure of any existing defaults (except unenforceable provisions discussed below), compensates the non-debtor party for loss resulting from the default and provides adequate assurance of future performance under Section 365(b)(1) and (f)(2)(B).

The term “adequate assurance” is not defined in the Code. However, most courts have held that the term was intended to be given a practical, pragmatic construction.\textsuperscript{36} Simply put, the test is whether the debtor has established a foundation that is non-speculative and sufficiently substantive to warrant the reasonable conclusion that the default will be cured and all obligations performed as required under the contract.\textsuperscript{37}

**B. Practice Tips**

1. To address case law prohibiting assumption of intellectual property licenses, the licensee will want the license to allow assumption or retention of the license in a bankruptcy proceeding, even when the license prohibits or restricts assignment. The licensor might limit any such “consent to assumption” provision to situations that do not involve an actual change of control over the licensee.

2. The debtor licensee will want to ensure that the licensor consents to assumption and assignment. Prior to filing for bankruptcy, the debtor should review all of its licenses to determine those that require licensor consent. If consent is required and licensors are unwilling, the debtor licensee may wish to consider alternatives to bankruptcy, and, if bankruptcy is necessary, whether a venue that applies the actual test is available.

3. The non-debtor licensor should be vigilant and object to a Chapter 11 plan or motion to assume the license to the extent that such an objection makes business sense. An assumption may actually be good for a licensor who wishes to have defaults cured rather than to deny ongoing use to the debtor in possession or trustee. In that case, the licensor should confirm that the cure amount to be paid in connection with assumption is accurate and is to be promptly paid.
V. What happens if a license is rejected by a trustee or a debtor in possession?

A. General Principles

1. Rejection is subject to the business judgment test.

Executory contract rejection is automatic in Chapter 7 liquidation cases, if the trustee does not assume the contract within 60 days or such further period as extended by court order. Except for automatic rejection in Chapter 7 cases, the bankruptcy court must approve a request by the debtor in possession or trustee to reject an executory contract. The standard generally followed is the so-called "business judgment" test. Under that test, rejection is a management decision within the reasonable business judgment of the debtor or trustee and will not readily be second guessed by the court.38

Although the business judgment test is typically construed as extremely deferential to the trustee or debtor in possession, where rejection would be provably detrimental to the estate or the benefits of rejection extremely speculative, the court may disapprove.39 Occasionally, some courts have also considered the disproportionate impact of rejection on the non-debtor party in comparison to any asserted benefit to the bankruptcy estate.40 Similarly, courts will refuse to allow rejection for an improper purpose.41

Section 365(n) of the Bankruptcy Code (as discussed infra) may limit the reasonableness of rejection. In Matusalem & Matusa of Florida, Inc., 158 B.R. 514 (Bankr. S.D. Fla. 1993), the debtor owned intellectual property, including a secret formula and a trademark.42 The debtor sought to reject a franchise agreement, pursuant to which the franchisee/licensee enjoyed the exclusive right to use certain secret processes and formulas for the manufacture of rum products, the exclusive right to use the name “Matusalem” and related names for the sale of those rum products, and the exclusive right to manufacture, distribute, and sell those rum products in Puerto Rico, the United States, and Central and South America. The franchisee paid an initial fee and had the obligation to pay royalties during the life of the agreement.43 The bankruptcy court found that the debtor had not been engaged in active business operations involving the distillation, distribution, or sale of rum products for about twelve years, yet the debtor was “seeking to begin a new speculative business venture by destroying its franchisee . . . and then operating a rum distillation and distribution company in the same manner as a managed health care business. The court is persuaded that this is not good business judgment.”44 Furthermore, the court found that “[e]ven if rejection were permitted, it would not automatically result in the termination of [franchisee’s] exclusive rights to manufacture and sell these products within its territorial area. . . Thus, rejection under § 365(n) would not deprive [franchisee] of its rights under the franchise agreement. It would, however, make the Debtor potentially liable for a rejection claim.”45 There would be no benefit to the estate,
and thus the court denied rejection.

2. Rejection of one license may constitute a default under another.

Even prior to the enactment of the current Bankruptcy Code, executory contracts and leases had to be assumed in their entirety. A debtor in possession or trustee could not pick and choose those portions that it wished to enforce and those portions that it wished to reject. However, the Ninth Circuit Bankruptcy Appellate Panel has held that a court may construe multiple obligations in an agreement as severable under state law, thus allowing assumption of specific obligations.

This requirement generally includes adherence to cross-default provisions. However, some courts have relied on equitable grounds in refusing to honor cross default provisions. Such courts analogize particularly onerous cross default provisions to unenforceable ipso facto and anti-assignment clauses.

3. Section 365(n) provides special protection to licensees of intellectual property against the impact of rejection.

Because of the harsh impact of rejection, certain classes of non-debtor parties have been provided with protection under the Bankruptcy Code, mitigating the effects of rejection. For example, where the debtor is a lessor of real property or timeshare interests, the non-debtor lessee or timeshare lessee has the option of treating the lease or timeshare plan as terminated or, in the alternative, remaining in possession of the leasehold or timeshare interest for the balance of the term and any renewal periods, provided that the lessee or timeshare participant pay the rent reserved under the lease or moneys due under the timeshare agreement for the balance of the term, less any damages for future non-performance of obligations of the debtor. Special protection also exists for non-debtor real estate vendees.

In response to the harsh result in cases allowing rejection of intellectual property contracts, such as Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043 (4th Cir. 1985), Congress amended Section 365 of the Bankruptcy Code to protect non-debtor licensees of intellectual property. In the event of rejection, the non-debtor licensee may elect to treat the contract as terminated or retain its license rights for the duration of the contract and any applicable extensions. If the licensee elects to retain its rights, it must make all royalty payments and waive claims and offset rights for prior non-performance. The licensee cannot, however, enforce obligations of the debtor to provide maintenance, technology updates or other services.

Care should be taken in drafting so that the royalty to be paid for retaining the intellectual property rights does not include payment for services no longer performed by the debtor after rejection or for post-petition, post-rejection improvements or modifications.
Buyers of intellectual property, even free and clear of liens, need to be aware that such a sale may be subject to the Section 365(n) rights of licensees, even if those licenses are not assigned under the purchase agreement.\(^{52}\)

If the licensee retains its rights, the trustee must continue to provide it with any intellectual property held by the trustee and not interfere with the licensee’s right to obtain the intellectual property from another entity.\(^{53}\) Section 365(n) also requires the trustee or debtor in possession to continue to provide the licensee with the intellectual property in the limbo period prior to rejection or assumption. For example, a licensee should be provided access to software source code held in escrow pursuant to a license even during the limbo period.\(^{54}\) Another consequence of the provision limiting retained rights to “…such rights as existed immediately before the case commenced…” is that the license must exist pre-petition. The license can not spring into existence post-petition pursuant to a pre-petition contract term.\(^{55}\) Also, the protected rights do not include the right to future intellectual property, coming into existence post-petition.

There are also some limitations on the range of intellectual property interests protected under Section 365(n). Section 101(35)(A) of the Bankruptcy Code defines intellectual property as including trade secrets, inventions and works of authorship protected under Title 17, but does not include trademarks. Thus, a non-debtor licensee of trademarks is not protected under §365(n) in the event of rejection of the license agreement. This is an important exclusion from Section 365(n) protections.\(^{56}\)

In the Seventh Circuit, a licensee of intellectual property may not be able to rely on Section 365(n) to afford it protection in the event of a sale free and clear of liens, claims and interests. In a case that addressed the right of a lessee of real property to retain its rights under the lease following a sale “free and clear,” the Seventh Circuit held that despite the protections granted by Section 365(h), the lessee’s interest was extinguished by a sale free and clear of interests under Section 363(f). It stated that “Congress authorized the sale of estate property free and clear of ‘any interest,’ not ‘any interest except a lessee’s possessory interest.’” Section 365(h) grants certain protections to lessees of real property, allowing them to remain in possession for the balance of the lease term following a rejection of the lease by the debtor/landlord.\(^{57}\) By analogy, the Seventh Circuit’s logic could be equally applicable to the interest of a licensee of intellectual property to retain its rights under Section 365(n). At least one bankruptcy court has refused to follow the Seventh Circuit in the context of Section 365(h).\(^{58}\)

4. Rejection may impact rights of secured creditors in a license and prior transfers of interests in the intellectual property.

Rejection of an executory contract does not retroactively void the agreement; it merely excuses the bankruptcy estate’s future performance and creates a damage
claim for breach of performance. Non-executory aspects of an agreement are not disturbed. Asset transfers completed prior to rejection are not generally affected. Thus, the security interests perfected pre-petition survive regardless of later rejection of the lease or contract as to which the security interest was granted.\textsuperscript{59}

Similarly, rejection does not terminate the non-debtor party’s rights against non-debtor obligors or guarantors. Numerous courts have referred to Section 365(n) to support the holding that rejection of an executory contract is not the equivalent of termination of such contract. Section 365(n) demonstrates this distinction, because it plainly states that rejection does not result in termination unless the licensee elects to treat an interest as terminated.\textsuperscript{60}

C. Practice Tips

1. Draft the original license agreement to expressly refer to and state that it is subject to Section 365(n). The license agreement should also provide that the failure to perform continuing obligations constitutes a material breach of the contract excusing performance by the licensee, or otherwise define events constituting a material breach, so as to increase the likelihood that it will be considered an executory contract.

2. The license agreement should require the licensor to provide the licensee any intellectual property and any embodiment of that intellectual property held by the licensor, adequately described.

3. The license agreement should permit the licensee to provide the licensed intellectual property to third parties without violating non-disclosure or exclusivity provisions.

4. The license agreement should separate “royalty payments” made for the use of the intellectual property itself from the payments made for other services. Alternatively, the license may provide for reduction of royalty payments in the event of non-performance of maintenance, support and upgrade provisions by the licensor. Trademark royalties should be spelled out separately and reduced in the event of non-performance by the licensor.

5. The license agreement should require technology escrows and recovery of the escrowed materials during a bankruptcy case. In a technology escrow, the parties entrust essential information and data, such as source code, with a trusted third party.

6. The licensee may be able to create a disincentive to rejection through special termination fees or liquidated damage provisions accelerating payment of future royalties.
7. Whether a licensee or licensor, consider taking a security interest in the counterparty’s interest in the intellectual property.

8. A lender with a security interest in intellectual property should obtain from the licensor an agreement to provide the lender with notice and opportunity to cure defaults, as well as permission to take an assignment of the license and to further assign the license to an eventual purchaser. The lender might also seek agreement from the licensor to enter into a replacement license if the borrower’s license is rejected in bankruptcy. If a lender has been granted a security interest in the executory contract itself, this collateral is at risk in the event of rejection.

9. Be vigilant and prepared to object to a motion to reject the license, a motion to sell the underlying intellectual property free of liens and interests or the confirmation of a Chapter 11 plan so providing.

VI. Can assumption, assignment, and rejection issues be avoided by “ride through”?

A. General Principles

Some commentators have suggested the employment of a “ride through” strategy to avoid the potentially harsh effects of the “hypothetical test.” This strategy is premised on the fact that the Bankruptcy Code contains no formal requirement that a debtor in possession reject or assume an executory contract, and involves simply allowing the contract to “ride through” the bankruptcy without rejection or assumption, until it re-vests in the reorganized debtor.

At least two bankruptcy courts have permitted the use of the “ride through” strategy with respect to an exclusive patent license. In In re Hernandez, 287 B.R. 795 (Bankr. D. Ariz. 2002), the court held that a license could "ride through" and become binding on the reorganized debtor. In doing so, the court applied a four factor test to determine whether a ride through should be permitted. The four factors are (1) the damage that other party to contracts would suffer, beyond compensation available under the Bankruptcy Code; (2) the importance of the contracts to the debtor's business and reorganization; (3) whether the debtor has had sufficient time to appraise its financial situation and potential value of its assets in formulating a plan; and (4) whether the exclusivity period has terminated. Hernandez, 287 B.R. at 806.

Similarly, in In re JZ, LLC, Case No. 01-03545-TLM, ______ B.R. ___, 2006 WL 3782988 (Bankr. D. Id. Dec. 21, 2006), the court held that a license to manufacture and distribute a patented grinder “rode through” a completed Chapter 11 case.
Other commentators have been wary to suggest the “ride through” strategy, noting that in some circuits, the failure to formally assume an executory contract may be fatal, leaving the licensor with a post-confirmation argument that the license was rejected. Moreover, it is important to note that many contracts have ipso facto clauses, which although unenforceable under Section 365(e)(1), cannot be avoided except through the assumption of the contract. Thus, in most situations, “ride through” may not be possible. In particular, under the 2005 changes to the Bankruptcy Code, “ride through” is expressly not available to individual debtors who are lessees under unexpired personal property leases.

B. Practice Tips

1. Ensure that the license is definitively dealt with in the bankruptcy either through assumption or rejection in order to reduce uncertainty.

2. Consider “ride through” in circuits where the hypothetical test is employed.

VII. Conclusion

Knowledge of the impact of bankruptcy on intellectual property licenses is of importance to licensors, licensees, and secured lenders in maximizing the value of their intellectual property rights and collateral. The potentially harsh effects of anti-assignment restrictions and the prohibition on assumption of non-assignable contracts can be overcome by obtaining the prior consent of the licensor to assignment. Debtors in possession and trustees should also analyze what potential use can be made of existing license rights during the bankruptcy case even if, ultimately, the license must be rejected.

Licensors should keep in mind the benefits of moving early for assumption or rejection of the license, especially if it is uncertain whether post-petition use of the licensed rights will result in a priority administrative claim.

Licenses should maximize the protection against rejection provided in 11 U.S.C. § 365(n) and realize its limitations and restrictions. Trademark licenses are not protected under Section 365(n). Future improvements and modifications to patented inventions or copyrighted work created after the date of petition are not protected. Additionally, Section 365(n) provides no protection for license rights “springing into existence” after the date of the petition. Besides providing source code escrows or equivalent protections to fully take advantage of the rights provided under Section 365(n), licensees may also want to consider taking a security interest in the underlying intellectual property rights of the licensor to secure any actual damages resulting from rejection or non-performance of the license. Finally, to avoid litigation over the extent of royalty payments to be paid by the licensee for continued utilization of the license rights, the royalty being paid for the intellectual property should be specifically defined separately in the license from any.
consideration being paid for other services or rights provided in the same contract.

2 For example, in In re Valley Media, Inc., 279 B.R. 105, 143 (Bankr. D. Del. 2002) (holding that vendors of copyrighted compact discs, DVDs, and VHS tapes could block post-petition distribution of the copyrighted material where license was terminated pre-petition).
3 In re AGI Software, 199 B.R. at 860 (granting declaratory judgment against non-debtor licensee that no rights existed under Section 365(n) where debtor licensor terminated license pre-petition).
4 See, e.g., In re Waterkist Corp., 775 F.2d 1089 (9th Cir. 1985) (possession of leasehold premises coupled with state anti-forfeiture laws may allow debtor to assume purportedly terminated lease).
6 11 U.S.C. § 544(a)(1), (b)(1); In re World Auxiliary Power Co., 303 F.3d 1120 (9th Cir. 2002) (holding that strong-arm power could not avoid security interest in unregistered copyrights as UCC filing was sufficient to perfect); In re Peregrine Enter., Ltd., 116 B.R. 194 (C.D. Cal. 1990) (holding that secured creditor’s interest in registered copyrights could be avoided using strong-arm powers where no filing was made with the United States Copyright Office).
7 In re Valley Media, Inc., 279 B.R. at 138 (citing In re West Electronics, Inc., 852 F.2d 80, 82 (3rd Cir. 1988)).
8 See, e.g., In re Computer Communications, Inc., 824 F.2d 725 (9th Cir. 1987) (substantial damages awarded against non-debtor party where, absent court order, the non-debtor party purported to exercise an “at-will” contract termination provision); see also In re Redpath Computer Servs., 181 B.R. 975 (Bankr. D. Az. 1995). But see In re Lucre, Inc., 339 B.R. 648, 657 (Bankr. W.D. Mich. 2001) (holding that non-debtor party’s performance under executory contract cannot be compelled by debtor pending assumption where defaults by debtor exist).
9 In re Valley Media, Inc., 279 B.R. at 137.
12 See, e.g., In re Dant & Russell, Inc., 853 F.2d 700, 707 (9th Cir. 1988); In re Coast Trading Co., 744 F.2d 686 (9th Cir. 1984); Union Leasing Co. v. Peninsula Gunite, Inc., 24 B.R. 593 (Bankr. 9th Cir. 1982); see also In re National Refractories & Minerals Corp., 297 B.R. 614, 618 (Bankr. N.D. Cal. 2003) (noting that requirement of benefit to estate in Dant & Russell has been superseded by statute in Section 365(d)(3) as to unexpired leases of non-residential real property).
13 See, e.g., In re Kmart Corp., 293 B.R. 905 (Bankr. N.D. Ill. 2003) (software provider’s post-petition software modifications for use in store that never opened were of no value to estate).
14 See In re Dak Indus., 66 F.3d 1091 (9th Cir. 1995).
16 See, e.g., In re Tobago Bay Trading Co., 112 B.R. 463, 466-67 (Bankr. N.D. Ga. 1990) (lease provision prohibiting tenant’s liquidation sale was invalid); In re Garnas, 38 B.R. 221 (Bankr. D.N.D. 1984) (non-renewal of insurance policy based on debtor’s financial problems); In re B. Siegel Co., 51 B.R. at 164 (“terminable at will” provision in insurance policy surprisingly interpreted as unenforceable ipso facto clause within the scope of Section 365(e)(1)).
17 In re Footstar, Inc., 337 B.R. 785 (Bankr. S.D.N.Y. 2005) (holding that non-debtor party to executory contract was not entitled to enforce ipso facto clause where debtor did not intend to assign license.)


20 See, e.g., In re Rovine Corp., 5 B.R. 402 (Bankr. W.D. Tenn. 1980) (covenant not to compete sufficient); Lubrizol Enters. v. Richmond Metal Finishers, Inc., 756 F.2d 1043 (4th Cir. 1985) (technology licensor's duty to defend intellectual property rights, indemnify licensee and maintain confidentiality sufficient); In re Select-A-Seat Corp., 625 F.2d 290 (exclusive licensor's duty not to further license held sufficient). But see In re Stein & Day, Inc., 81 B.R. 263 (Bankr. S.D.N.Y. 1988) (non-debtor author's duty to indemnify publisher and offer future books for publication insufficient); see also In re Monument Record Corp., 61 B.R. 866 (Bankr. M.D. Tenn. 1986) (employment contract in which non-debtor artists had no further obligation to record).


24 Id.

25 See, e.g., In re Standor Jewellers West, Inc., 129 B.R. 200, 201-02 (Bankr. 9th Cir. 1991) (lease provision requiring remittance to lessor of proceeds of assignment deemed invalid under Section 365(f)); In re Peaches Records & Tapes, Inc., 51 B.R. 583, 590 (Bankr. 9th Cir. 1985); In re Vista VI, Inc., 35 B.R. 564, 567-68 (Bankr. N.D. Ohio 1983) (invalidating provision requiring tenant to operate under specific tradename).


27 See, e.g., In re West Electronics, Inc., 852 F.2d 79 (non-assignable government contract); In re Pioneer Ford Sales, Inc., 729 F.2d 27 (1st Cir. 1984) (franchise agreement where state law prohibited transfer without manufacturer's consent); In re Braniff Airways, Inc., 700 F.2d 935 (5th Cir. 1983)(restricted airport gate slots); In re Nite Paper Corp., 43 B.R. 492 (S.D.N.Y. 1984) (special low rate electricity supply contract).


29 Harris v. Emus Records Corp., 734 F.2d 1329 (9th Cir. 1984) (citing patent cases by analogy); Everex Systems, Inc. v. Cadtrax Corp. (In re CFLC, Inc.), 89 F.3d 673 (9th Cir. 1996) (non-exclusive pre-paid patent license non-assignable in bankruptcy); In re Catapult Entert., 165 F.3d at 749-50 (non-exclusive patent license).


32 See In re Sunterra Corp., 361 F.3d 257 (4th Cir. 2004)(holding debtor in possession was precluded from assuming non-exclusive copyright license even though debtor in possession did not intend to assign it) : Cinicola v. Scharfenberger, 248 F.3d 110, 126 (3rd Cir. 2001); In re Catapult Entert., 165 F.3d 747, 749-50 (9th Cir. 1999)(adopting “hypothetical test”); In re Catron, 158 B.R. 629, 638 (E.D. Va. 1993)(same), aff'd without opinion, 25 F.3d 1038 (4th Cir. 1994).


34 See, e.g., In re Valley Media, 279 B.R. 105.


41 See, e.g., In re Waldron, 785 F.2d 936 (11th Cir. 1986) (bad faith dismissal of Chapter 13 by bankruptcy attorney filed for purpose of rejecting unprofitable option agreement); In re Noco, Inc., 76 B.R. 839 (Bankr. N.D. Fla. 1987) (solvent debtors filed case to reject covenant not to compete; franchise agreement had also been substantially performed and was therefore non-executory).

42 Note that defining a trademark as intellectual property conflicts with Licensing by Paolo, Inc. v. Sinatra (In re Gucci), 126 F.3d 380 (2d Cir. 1997).

43 See 158 B.R. at 516.

44 Id. at 521.

45 Id. at 522.


47 In re Pollock, 139 B.R. 938 (Bankr. 9th Cir. 1992).


49 See, e.g., In re Sambo’s Restaurants, Inc., 24 B.R. 755 (Bankr. C.D. Cal. 1982) (court refused to enforce cross-default provisions applying to 10 separate leases of restaurant properties to the debtor); In re Wheeling-Pittsburgh Steel Corp., 54 B.R. 772 (Bankr. W.D. Pa. 1985) (court refused to enforce cross-default provisions in four insurance policies tied to delinquent fifth policy), aff’d, 67 B.R. 670 (W.D. Pa. 1986); see also In re Madison’s Partner Group, Inc., 67 B.R. 633 (Bankr. D. Minn. 1986) (court required showing of “special consideration” furnished by Lessor to enforce cross-default tied to contract to which debtor was not a party).


51 See Encino Business Mgmt. v. Prize Frize, Inc. (In re Prize Frize, Inc.), 32 F.3d 426 (9th Cir. 1994).

52 In re Cellnet Data Sys., 327 F.3d at 252 (requiring purchaser of intellectual property rights from debtor to comply with rejected license obligations while debtor remains entitled to royalty payments from licensee).

53 See In re El Int’l., 123 B.R. 64, 66 (Bankr. D. Id. 1991) (holding that license was treated as terminated with damages calculated as if license were breached pre-petition where licensee did not affirmatively elect to retain benefits).


56 In re Gucci, 126 F.3d at 394 (concluding that trademarks are not intellectual property for the purposes of Section 365(n)).
57 Precision Indus., Inc. v. Qualitech Steel SBQ, LLC, 327 F.3d 537, 548 (7th Cir. 2003).
62 As explained by the Fifth Circuit, “If an executory contract is neither assumed nor rejected, it will ‘ride through’ the proceedings and be binding on the debtor even after a discharge is granted, thus allowing the non-debtor's claim to survive the bankruptcy.” In re National Gypsum Co., 208 F.3d 498, 504 n.4 (5th Cir. 2000) (citing Federal's, Inc. v. Edmonton Inv. Co., 555 F.2d 577, 579 (6th Cir. 1977)).
63 The test employed by the court was originally set out by the Second Circuit in Theatre Holding Corp. v. Mauro, 681 F.2d 102 (2d Cir. 1982), to determine whether a debtor should be allowed to delay the assumption or rejection of an executory contract. See In re Adelphia Communications Corp., 291 B.R. 283, 292 (Bankr. S.D.N.Y. 2003) (noting that Theatre Holding factors were developed and applied to unexpired lease of non-residential real property prior to amendment of Section 365(d)(4) shortening time to assume or reject this type of lease, but that otherwise determination of enlargement of time is left to court’s discretion).
64 See, e.g., David R. Kuney, Intellectual Property Law in Bankruptcy Court: the Search for a More Coherent Standard in Dealing With a Debtor’s Right to Assume and Assign Technology Licenses, 9 Am. Bankr. Inst. L. Rev. 593, 636 (citing Sea Harvest Corp. v. Riviera Land Co., 868 F.2d 1077, 1079 (9th Cir. 1989) (the statutory presumption of rejection, unless the debtor or trustee acts affirmatively to assume a lease, protects the estate from unexpected liability)).