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Certain Issues Related to Financing Intellectual Property Subject to Licenses*

* Christopher G. Dorman, Phillips Lytle LLP
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Introduction.

Value from intellectual property (IP) is often derived from rights held under licenses, whether debtor is the licensor or the licensee. Creditors and Debtors should be sensitive to a number of issues when structuring loans secured by collateral packages that include licenses.

This outline is intended to address some of those issues.

1. **LICENSES.** A license is a grant by the owner of IP, the licensor, that gives the licensee a right to use (a) a patent in connection with activities such manufacturing or other processes, (b) reproducing, selling, or distributing copyrighted work, or (c) using a trademark in connection with the sale or distribution of certain products, or in a particular region or territory. Licensees pay the licensor royalties and/or other consideration in exchange for the right to use the IP without the threat of being sued by the licensor for infringement.

For Lender’s, value may be in the flow of royalties to the Licensor from licenses or in the intrinsic value of the rights granted in the license. For Licensors there may value in a royalty stream – possibly from markets not yet tapped into, ability to deploy technology more efficiently. For Licensees there is value in the right to use the IP with having to develop technology, create an idea or foster goodwill.

(a) **Exclusive License.** – Exclusive licenses grant the licensee the exclusive right to use the property subject to the terms of the license. Such licenses grant property rights, not just personal rights, to the licensee. An example of a grant of an exclusive license is:

“Licensor hereby grants to Licensee an exclusive license, with the right to sublicense to others, to make, have made, use, sell and lease products described in the Licensed Patent Rights. Licensor retains the right to continue to use Licensed Patent Rights in any way for non-commercial purposes. It is understood by the Licensee that the Licensed Patent Rights were developed under Grant No. XXXXX, and that the United States Government has a non-exclusive royalty free license to use the Licensed Patent Rights for governmental purposes.”

(b) **Nonexclusive License.** – Nonexclusive licenses grant the licensee limited rights to use the subject IP. Nonexclusive license are considered personal rights to the licensee – Not a property right.

A sample of a grant of a nonexclusive license is:

“Subject to the limitations set forth in this license, Licensor grants to Licensee a nonexclusive license to use the Licensed Patent Rights in the Territory. The license granted herein is limited to use of the Licensed Patent Rights solely for the manufacture and production of electronic cat and kitten dryers more fully described on Exhibit A. The license granted herein does not include the right to sell or lease the Licensed Patent Rights; provided however, that such limitation shall not affect Licensee’s ability to commercialize any material that is discovered
using the Licensed Patent Rights. The license granted herein does not include the right to grant sublicenses to third parties to use Licensed Patent Rights. The license granted herein is subject to: (a) all the applicable provisions of any license to the United States Government executed by Licensor, and shall be subject to the overriding obligations to the U.S. Government under [certain application statutes] and applicable governmental implementing regulations; and (b) the overriding obligations to XYZ Corp.; provided, however, that none of the provisions or obligations in (b) above shall restrict the ability of Licensee to exercise its rights hereunder.”

(c) Assignment. – Weight of authority is that Licensee cannot assign its rights under an exclusive or non-exclusive license of IP without consent of licensor.

2. **DUE DILIGENCE.**
   - Grant
     - What’s included and how and where can it be used
   - Term
     - Renewal and extension, life of IP
   - Territory
   - Financial
     - Cost to Licensee
     - Consider (i) new markets, distribution chains, (ii) expansion of inventory, (iii) new products, product line
     - Value to Licensor
     - Fixed Royalty – initial fee and guarantied minimum royalty
       - Other revenue (advertising fees, late charges)
       - Royalty based on sales
       - Reimbursement for certain costs
       - Insurance
   - Controls by Licensor
     - Quality
     - Packaging
   - Representations/Covenants – Licensor/Licensee
     - License to report sales, keep records, marketing plan
     - Maintenance of IP rights (filing and prosecuting application), (maintenance, updates, service (escrow)) use affidavits, defend against infringement
   - Defaults
   - Confidentiality
   - Governing Law
   - Assignment

3. **IP LICENSES AND ARTICLE 9 OF THE UCC.**

   (a) (i) Borrower grants security interest in assets, (ii) Secured Party gives value, and (iii) perfection. UCC 9-310 to 9-316.
Article 9 of the Uniform Commercial Code (UCC) provides in Section 9-102(a)(2) that the term “Accounts” includes rights to payment for licensed property. This includes the right to payment under a license of intellectual property.

Section 9-102(a)(42) defines “General Intangibles” to include things in action such as rights arising under a license of IP, including the right to use the IP without being sued for infringement.

Section 9-408 provides that restrictions on assignments are generally ineffective. So, a security interest may be granted by licensee in the licensee’s rights in the subject property, without causing default, but to realize on such rights, a licensor’s consent is necessary.

Section 9-408 is designed to make the value of otherwise nonassignable rights under a license available to licensees so they can monetize the right. Although, enforcement may be a problem vis a vis the licensor, the secured party would have a perfected security interest against a bankruptcy trustee. In the event the licensed property included confidential information, the secured party would not have access to that property right under Section 9-408. But if Licensee is able to monetize its rights in the licensed property, the secured party would be entitled to enforce its security interest in the proceeds generated by transfer of the licensee’s rights. For example, if the Licensor consented to a sale of goods using a licensed trademark in a bankruptcy, the secured party’s security interest in the proceeds would be good.

Section 9-321 seeks to protect “licensees in ordinary course of business”, which is a “licensee of a general intangible in good faith, without knowledge that the license violates the rights of another person in the general intangible, and in the ordinary course from a person in the business of licensing general intangibles of that kind.” 9-321(b) provides that “[a] licensee in the ordinary course of business takes its rights under a nonexclusive license free of a security interest in the general intangibles created by the licensor, even if the security interest is perfected and the licensee knows of its existence.”

This protects a nonexclusive licensee from the licensor’s secured party. The provision affects rights of a secured party and the licensee of the secured party’s borrower, not the rights between licensor and licensee.

If a licensee holds a nonexclusive license granted by a sub-licensor that holds an exclusive license to use the intangible from a licensor then that sub-licensor’s secured party forecloses, the nonexclusive licensee could continue to enjoy its rights under the license. If the licensor’s secured party forecloses, then the sub-licensor holding an exclusive license would lose its rights in the license. The rights of the licensee as a nonexclusive sublicensee would also be subject to the foreclosure since it is only protected against the secured party of its immediate sublicensor.

4. **CERTAIN BANKRUPTCY CONSIDERATIONS.**

(a) **Executory Contracts.** – A widely accepted standard for determining whether a contract is an executory contract is when “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

Obligations to account for and pay royalties have been found make a contract executory. Obligations such as reporting on problems, marking goods produced with patent notice can make a contract executory.

Obligation not to sue for infringement is subject to debate as to whether it makes contract executory.

(b) Assumption, Rejection and Assignment.

(i) Section 365(a) of the Bankruptcy Code provides that a trustee, subject to court approval, may assume or reject any executory contracts. Courts apply business judgment rule in determining whether to allow rejection or assumption. The party that wants to reject the contract has the burden of showing that the contract is executory.

(ii) In *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985), Richmond Metal Finishers granted Lubrizol Enterprises a nonexclusive license to use a patented metal coating process. After Richmond Metal filed for bankruptcy protection, it sought to reject the license with Lubrizol under §365(a) of the Bankruptcy Code so it could sell or license the technology, a metal coating process. The court allowed the rejection and noted that doing so “imposes serious burdens upon contracting parties such as Lubrizol…[and] . . . allowing rejection in this and comparable cases could have a general chilling effect upon the willingness of [IP Licensees] to contract at all with business in possible financially difficulty.”

The court observed that Congress plainly provided for the rejection of executory contracts notwithstanding the obvious adverse consequences.

Congress subsequently, enacted Section 356(n) of the Bankruptcy Code, which is discussed below.

(iii) Section 365(f) provides that notwithstanding prohibitions, restrictions or conditions on assignment in an executory contract or applicable law, the trustee may still assign the contract if the trustee assumes that contract and provides adequate assurance of performance.

(iv) Section 365(c)(1) of the Bankruptcy Code provides that “the trustee may not assume or assign an executory contract or unexpired lease of the debtor, whether or not such a 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.”

(c) The Intellectual Property Bankruptcy Protection Act.

Section 365(n) (1) of the Bankruptcy provides that “if the trustee rejects executory contract under which the debtor is a licensor of a right to intellectual property, the licensee under such
contract may elect – (A) to treat such contract as terminated by such rejection if such rejection by
the trustee amounts to such a breach as would entitle the licensee to treat such contract as
terminated by virtue of its own terms, applicable non-bankruptcy law, or an agreement made by
the licensee with another entity; or (B) to retain its rights (including the right to enforce any
exclusivity provisions of such contract, but excluding any other right under applicable non-
bankruptcy law to specific performance of such contract) under such contract and under any
agreement supplementary to such contract, to such intellectual property (including any
embodiment of such intellectual property to the extent protected by applicable non-bankruptcy
law), as such rights existed immediately before the case commenced, for – (i) the duration of
such contract; and (ii) any period for which such contract may be extended by the licensee as of
right under applicable non-bankruptcy law. (2) If the licensee elects to retain its rights, as
described in paragraph 1(B) of this subsection under such contract – (A) the trustee shall allow
the licensee to exercise such rights; (B) the licensee shall make all royalty payments due under
such contract for the duration of such contract and for any period described in paragraph 1(B) of
this subsection for which the licensee extends such contract; and (C) the licensee shall be
deemed to waive – (i) any right of setoff it may have with respect to such contract under this title
or applicable non-bankruptcy law; and (ii) any claim allowable under Section 503(b) of this title
arising from the performance of such contract. (3) If the licensee elects to retain its rights, as
described in paragraph 1(B) of this subsection, then on the written request of the licensee the
trustee shall – (A) to the extent provided in such contract, or any agreement supplementary to
such contract, provide to the licensee any intellectual property (including such embodiment) held
by the trustee; and (B) not interfere with the rights of the licensee as provided in such contract, or
any agreement supplementary to such contract, to such intellectual property (including such
embodiment) including any right to obtain such intellectual property or such embodiment from
another entity. (4) Unless and until the trustee rejects such contract, on the written request of the
licensee the trustee shall – (A) to the extent provided in such contract or any agreement
supplementary to such contract – (i) perform such contract; or (ii) provide to licensee such
intellectual property (including any embodiment of such intellectual property to the extent
protected by applicable non-bankruptcy law) held by the trustee; and (B) not interfere with the
rights of the licensee as provided in such contract, or any agreement supplementary to such
contract, to such intellectual property (including such embodiment), including any right to obtain
such intellectual property (or such embodiment) from another entity.”

Section 365(n) allows certain IP Licensees to keep their rights in licensed IP, irrespective of the
Licensor’s rejection. The rights that they keep are the rights that they have as of the day of the
bankruptcy filing period and include the right to enforce an exclusivity provision and the right to
use the IP for the remainder of the term of the license. Payment of royalties is required.

Note that Section 101(35A) of the Bankruptcy Code defines “Intellectual Property” to include
copyrights, patents and trade secrets, but not trademarks.

(g) Assumption and Assignability.

(i) 365(c). There is disagreement among the courts on how to apply Section 365 (c) of
the Bankruptcy Code, which says that a trustee or debtor-in-possession cannot assume an
executory contract if applicable law would allow the non-debtor party to refuse to accept
performance from or perform for a party other than the debtor.
Some courts apply the “hypothetical” test, which prohibits the trustee or debtor-in-possession from assuming a contract if applicable law would prohibit assignment irrespective of whether an assignment was planned. See, *In re Catapult Entertainment, Inc.*, 165 F.3d 747 (9th Cir. 1999), where when licensor sought to reject a debtor-in-possession’s assumption of a license, the court applying the “hypothetical” test held that “where applicable nonbankruptcy law makes an executory contract non-assignable because the identity of the nondebtor party is material, a debtor-in-possession may not assume the contract absent consent of non-debtor party”. In *Catapult*, the licensee, Catapult Entertainment, Inc. lost the right to use certain technologies in connection with an online gaming network.

This result has been described as “harsh” because it denies licensees the benefit of what had been bargained for when entering into the license. The “hypothetical” test has been accepted by three circuit courts (9th, 3rd and 4th).

The alternative approach is described as the “actual” test and turns on whether the debtor is actually going to assign the license and the non-debtor party would be required to accept performance from a party other than the debtor or the debtor-in-possession. Note that the statute says that a trustee may not “assume or assign” such an executory contract. This is the basis for much of the disagreement among the courts.

In *In re Aerobox Composite Structures, LLC*, 2007 WL 2178045 (Bankr. D. N.M. 2007), the bankruptcy court for the District of New Mexico adopted the “actual test”.

Tubus Bauer GmbH granted Aerobox an exclusive license within North America to use certain patent rights and confidential information for the in-house manufacture and use of Tubus Polypropelene honeycomb, and a nonexclusive license in North America for the use of certain patent rights and confidential information to manufacture Tubus Polypropelene honeycomb for resale as value added thermoplastic sandwich panels. The license had a 15 year term, with automatic renewal for indefinite term.

When Aerobox filed its chapter 11 petition, Tubus Bauer filed a motion to compel Aerobox to reject the license, and relied on the *Catapult* decision to support its case.

The court denied the motion, based on application of the “actual” test as set forth in *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1997).

The debtor's argued that the patent license was not executory because the license was pre-paid. The Court found that the license to be executory because of continuing material duties and obligations of both parties, e.g. Aerobox’s duty not to sell the thermoplastic core separately and to maintain confidentiality and Tubus Bauer’s obligation to defend the patent against challenges of validity.

The Court rejected Tubus Bauer’s argument to apply the “hypothetical” test and stated that the debtor-in-possession is not materially different from the prebankruptcy party to the contract. So, citing *Institut Pasteur*, the court observed that since “365 (c) (1) is aimed at protecting non-debtor parties from being forced to accept service from or render service to an entity other than the entity with whom it originally contracted, it is appropriate to determine whether the
The nondebtor party is actually being forced to accept performance under its executory contract from an entity other than the debtor”.

The court also looked to the reasoning in In re Footstar, Inc., 323 B.R. 566 (Bankr. S.D.N.Y. 2005) where, in deciding whether a debtor-in-possession could assume executory contracts with Kmart Corporation, the court reasoned that for purposes of section 365(c) the term "trustee" means just that, and does not encompass the term "debtor-in-possession." Thus, section 365(c) can only affect the right of a trustee to assume a contract, not a debtor-in-possession.

Footstar’s reasoning was followed by Judge Gerber in a decision in 2007 the Adelphia Communications Chapter 11 proceeding.

(iii) 365(n) In re Exide Technologies, (340 B.R. 222, April, 2006) Exide Technologies, Inc. and affiliated debtors sought to reject a set of agreements constituting a trademark and tradename license agreement with Enersys, Inc. The agreements provided that Exide granted Enersys a perpetual, exclusive royalty free license to use the Exide mark in the industrial battery business. Exide kept the right to use the mark outside of the industrial battery business. The dispute revolved around whether the contract was an executory contract and whether Exide had the right to reject the agreement in bankruptcy and whether Enersys could keep its rights under the license under §365(n) of the Bankruptcy Code irrespective of the rejection.

For a number of reasons, the court found that the contract was an executory contract including: (i) the fact that Exide was required to refrain from suing Enersys for trademark infringement, for the use of the Exide mark; (ii) Enersys was required to refrain from using the Exide mark from outside of the industrial battery business; (iii) Exide was prohibited from using the Exide mark within the industrial battery business; (iv) Enersys was required to maintain a level of quality for its produces that contained that mark; (v) Exide had to make payments into a pension plan maintained for the benefits of its employees; (vi) Exide was required to maintain registration of the Exide mark; (vii) Enersys and Exide were required to indemnify each other against certain costs, losses, liabilities, damages, etc. and (viii) Exide and Enersys were required to cooperate with another after the closing of the agreement in order to effectuate certain provisions of that agreement. For those reasons, that the a contract was a executory contract and the court found that Exide had a termination right in the event of breach. Certain of the contracts requirements, including to requirement to maintain quality standards or if there was an assignment of sublicense of the mark.

In a brief reference to Bankruptcy Code Section 365(n), the court noted that it does not provide Enersys with any protection from the rejection because this section of Bankruptcy Code does not include trademarks, the court stated that trademark licensees, such as Enersys, cannot use 365(n) to elect to retain their rights to use a mark after a rejection by licensor.
Scenario 1

Debtor manufactures goods utilizing a patented method pursuant to a non-exclusive license from third party. Lender lends on Debtor’s accounts and inventory and takes a security interest on all assets.

- **Due Diligence**
  - Review License
  - Prohibition on Assignment
  - Debtor obligations

- **Effect of Debtor default/Bankruptcy**
  - §9-321 of UCC
  - §9-408 of UCC
  - Agreement from Licensor allowing Lender right to continue use of patent for limited period to complete WIP (Compare debtor/licensee of trademark).

- **Licensor default/bankruptcy**
  - Inability to perform
  - Rejection of license
  - §§365(c) and 365(n) of Bankruptcy Code
Scenario 2

Debtor owns well known trademark. Lender makes loan secured by all assets, including trademark and royalty flow from licensees. Trademark is licensed by debtor to a number of licensees pursuant to non-exclusive licenses.

- Due Diligence
- Licensee Agreement containing notice and acknowledgment of security interest with direction to pay Lender
- Licensee default
- Licensor default
- Licensee sublicense to sublicense – Rights of licensee of Debtor are not subject to being cut off in foreclosure if the license is nonexclusive and the licensee is performing under the License. Section 9-321 recognizes that a Secured Party is able to monitor its borrower from entering into nonexclusive licenses, but is not able to monitor and prevent the licensees of the borrower from entering into nonexclusive licenses.
Scenario 3

- Debtor owns patent which is a method for accessing and processing data over the internet and preparing reports according to subscriber specifications. Debtor is licensee under a number of exclusive and non-exclusive licenses that permit use of web-based technology and content and allow access and use of various databases to collect and organize financial information and financial news. Debtor also has a license to use a well known trademark in its business. Secured Party makes loans secured by all assets including accounts, patent and rights in general intangibles.

  - **Patent**
    - value of patent in the deal or business enterprise based on patent and licenses
    - infringement suit against debtor
    - life of patent

  - **Licensors** – comprised of licenses to use patents, copyrights and trademarks or combinations thereof
    - License to use trademark is not assignable and licensor is unwilling to consent assignment
    - Some licenses silent on assignment, some prohibit assignment and some prohibit assignment with consent not to be unreasonably withheld
    - default/bankruptcy of licensors may jeopardize all or part of business enterprise

  - **Licensee**
    - default/bankruptcy of licensee (operation of §365 – While licensors may attempt to deny debtors assumption of licenses, licensee/debtor may be able to preserve right to use patents and copyrights, but may lose right to trademarks)