BANKRUPTCY AND LICENSING

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Introduction

The risk of bankruptcy looms over high-tech and low-tech U.S. companies alike. The prudent lawyer should have a thorough knowledge of the U.S. Bankruptcy Code as it impacts intellectual property licenses. If a licensee declares bankruptcy, the licensor will seek to maximize its control over the assumption and assignment of the IP license. If a licensor declares bankruptcy, the licensee will seek to ensure its continued right to use the licensed property. Meanwhile, bankrupt companies seeking to transfer their stockpiles of online consumer information have faced privacy challenges in the courts. Yet, by the time a bankruptcy occurs, it is too late to redraft the IP license for optimal protection; knowledge of the interface between the IP and bankruptcy laws should inform one's drafting practices on day one.

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I. Business Climate

A. Vast increase in Internet/e-commerce bankruptcies

1. In 2000-2003, more than 962 "substantial" internet companies shut down or declared bankruptcy. A majority (608) of those shutdowns involved Internet "destination" companies: web sites offering content or e-commerce services (www.webmergers.com).

2. The primary assets of many bankrupt Internet companies are rights existing under intellectual property ("IP") licenses; debtors may attempt to sell these assets through Chapter 11 plans. Companies such as

Bid4Assets have built businesses upon liquidation of bankrupt Internet company assets.

3. Today, the risk of bankruptcy affects even the largest and "lower-tech" U.S. companies; all prudent attorneys must consider the issue in drafting agreements.

II. IP Licenses in Bankruptcy

A. Section 365 – Executory Contracts (General)

1. Section 365 of the U.S. Bankruptcy Code, 11 U.S.C. § 365, governs "executory contracts" and unexpired leases of the debtor. Subject to the exceptions in Section 365(b) (cure of defaults), Section 365(c) (discussed below) and Section 365(d) (residential real property), Section 365(a) provides that the debtor may assume or reject any executory contract.

2. Subject to Section 365(c) (discussed below), pursuant to Section 365(f), the debtor may assign an executory contract, even if the contract itself or applicable law prohibits such assignment.

3. An executory contract is a contract in which "the obligations of both parties are so far unperformed that the failure of either party to complete performance would constitute a material breach and thus excuse the performance of the other." *In re CFLC, Inc.*, 89 F.3d 673, 677 (9th Cir. 1996); *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043, 1045-46 (4th Cir.1985), *cert. denied,* 475 U.S. 1057 (1986).

4. The above formulation essentially states the widely-cited definition of executory contracts attributed to Professor Vern Countryman. *See Sharon Steel Corp. v. National Fuel Gas Distribution Corp.*, 872 F.2d 36, 39 (3d Cir. 1989) and *In re Access Beyond Technologies, Inc.*, 237 B.R. 32, 43 (Bankr. D. Del. 1999), citing Countryman, Executory Contracts in Bankruptcy, Part I, 57 MINN.L.REV. 439, 460 (1973).

5. Some courts take a more expansive, functional approach as to which contracts are "executory," so as "to permit the trustee or debtor-in-possession to use valuable property of the estate and to renounce title to and abandon burdensome property." *In re Orion Pictures Corp.*, 4 F.3d 1095, 1098 (2d Cir. 1993).

B. Executory Contracts – IP/E-Commerce Agreements

1. E-commerce agreements typically involve a license to intellectual property and the performance of related services (*e.g.*, support, maintenance, improvements, customization).

2. Intellectual property licenses generally fit the definition of "executory contracts" under Section 365, because the licensor and licensee have material ongoing obligations: quality control, use of notice and legends, duty to defend and enforce the IP rights, duty not to sue each other, exclusivity obligations, etc.

   a. *CFLC*, 89 F.3d at 677 (noting that patent licensee must mark products, and licensor must refrain from suing licensee for infringement); *Access Beyond Technologies,* 237 B.R. at 44 (same; referring to such obligation as "significant and continuing," rendering license executory as to licensor).

   b. *Lubrizol Enterprises,* 756 F.2d at 1046 (licensor must give notice of and defend infringement suits and indemnify licensee, licensee had to maintain accounts to support royalty payments and deliver quarterly sales reports).

   c. *In re Kmart Corp.*, 290 B.R. 614, 618 (Bankr. N.D. Ill. 2003) (ongoing duties to, *inter alia*, notify licensee of claims and infringement allegations, protect software's trade secrets, and seek consent to transfer the software renders license executory).

   d. *In re HQ Global Holdings, Inc.*, 290 B.R. 507, 510-11 (Bankr. D.Del. 2003) (licensor's ongoing obligation to refrain from using trademark in designated territories, combined with licensee's obligation to pay royalties, sufficed to render contract executory).

   e. *In re Valley Media, Inc.* 279 B.R. 105, 135 (Bankr. D. Del. 2002) ("the Third Circuit follows the general rule that intellectual property licenses, including Copyright licenses, are executory contracts").

   f. *In re Patient Educ. Media, Inc.*, 210 B.R. 237, 241 (Bankr. S.D.N.Y. 1997) (nonexclusive copyright license not limited in time is executory for § 365 purposes).

III. Licensee Goes Bankrupt: Section 365(c)

A. Section 365(c) Provisions

1. Sections 365(a) and 365(f) allow the debtor to assume and then assign an executory contract, notwithstanding a provision in the contract or in applicable law that prohibits assignment, unless an exception in Section 365(c) applies. *See Cinicola v. Scharffenberger*, 248 F.3d 110, 120 (3d Cir. 2001).

2. Section 365(c) prohibits the trustee from assuming or assigning any executory contract, whether or not such contract prohibits or restricts such assignment, if:

   a. applicable law excuses the non-debtor from accepting performance from or rendering performance to an entity other than the debtor, whether or not such contract prohibits assignment; and

   b. the non-debtor does not consent to such assumption or assignment.

3. Section 365(c) has 3 components: (i) what is the "applicable law" that could excuse the non-debtor from accepting an assignee's performance? (ii) what type of contract requires consent to assign under such applicable law? and (iii) if an executory contract may not be assigned, may it nonetheless be assumed by the debtor?

B. Applicable Law

1. Most federal courts, including appellate courts, hold that the "applicable law" governing assignability of IP licenses under Section 365(c) is federal IP law and not state contract law. *Rhone Poulenc Agro, S.A. v. DeKalb Genetics Corp.*, 284 F.3d 1323, 1328 (Fed. Cir. 2002); *In re Catapult Entertainment, Inc.*, 165 F.3d 747, 750 (9th Cir. 1999); *In re CFLC, Inc.*, 89 F.3d 673, 677-79 (9th Cir. 1996); *Gilson v. Republic of Ireland*, 787 F.2d 655, 658 (D.C. Cir. 1986); *RCC Technology Corp. v. Sunterra Corp.*, 287 B.R. 864, 865 (D. Md. 2003); *In re Travelot Co.*, 286 B.R. 447, 455 (Bankr. S.D. Ga. 2002).

2. Applicable state law may also govern the issue. *In re Nedwick Steel Co., Inc.*, 289 B.R. 95, 97 (Bankr. N.D. Ill. 2003) (state law can also prohibit assignment of contracts).

3. One state-court case, now in doubt, holds that state contract law is the "applicable law" under Section 365(c). *Farmland Irrigation Co. v. Dopplmaier*, 48 Cal.2d 208 (Cal. 1957).

C. Qualifying Section 365(c) Contracts

1. Personal services contracts and contracts where the licensee's identity is material. *In re Magness*, 972 F.2d 689, 696 (6th Cir. 1992) (golf club membership); *In re West Electronics Inc.*, 852 F.2d 79, 83 (3d Cir. 1988) (government contract); *In re Supernatural Foods, LLC*, 268 B.R. 759, 789 (Bankr. M.D. La. 2001) (contracts in which identity of party is material to contract); *In re Alltech Plastics, Inc.*, 71 B.R. 686, 688 (Bankr. W.D. Tenn. 1987) (personal services contracts, leases of airport property, distributor agreements, agency contracts, real property leases (citations omitted)).

2. Non-exclusive IP licenses

a. Patents – Consent is required. *Rhone Poulenc Agro, S.A. v. DeKalb Genetics Corp.*, 284 F.3d 1323, 328 (Fed. Cir. 2002); *In re Catapult Entertainment, Inc.*, 165 F.3d 747, 750 (9th Cir. 1999); *Everex Systems, Inc. v. Cadtrak Corp.*, 89 F.3d 673, 679-80 (9th Cir. 1996), *Gilson v. Republic of Ireland*, 787 F.2d 655, 658 (D.C. Cir. 1986); *PPG Indus., Inc. v. Guardian Indus. Corp.*, 597 F.2d 1090, 1093 (6th Cir.), *cert. denied*, 444 U.S. 930 (1979); *Unarco Indus., Inc. v.* Kelley *Co.*, 465 F.2d 1303, 1306 (7th Cir. 1972), *cert. denied*, 410 U.S. 929 (1973); *Rock-Ola Mfg. Corp. v. Filben Mfg. Co.*, 168 F.2d 919, 922 (8th Cir.), *cert. dismissed*, 335 U.S. 855, *cert. denied*, 335 U.S. 892 (1948); *In re Supernatural Foods*, LLC, 268 B.R. 759, 794 (Bankr. M.D. La. 2001). *But see Farmland Irrigation Co. v. Dopplmaier*, 48 Cal. 2d 208 (Cal. 1957) (applying state contract law and not federal patent law to issue of license assignability).

b. Copyrights – Consent is required. *ITOFCA, Inc. v. MegaTrans Logistics, Inc.*, 322 F.3d 928, 941 (7th Cir. 2003); *In re Valley Media, Inc.*, 279 B.R. 105, 135-36 (Bankr. D. Del. 2002); *In re Buildnet*, 2002 WL 31103235 at *4 (Bankr. M.D.N.C. 2002); *See In re Patient Educ. Media, Inc.*, 210 B.R. 237, 240-41 (Bankr. S.D.N.Y. 1997); *SQL Solutions, Inc. v. Oracle Corp.*, No. C-91-1079 (MHP), 1991 WL 626458, at *4 (N.D. Cal. Dec. 18, 1991) (non-bankruptcy case; holding that non-exclusive copyright license cannot be assigned without licensor's consent); *See also Harris v. Emus Records Corp.*, 734 F.2d 1329 (9th Cir. 1984) (case under old Bankruptcy Act and not § 365(c); holding that non-exclusive license is not an interest in a copyright).

c. Trademarks – Consent is required. *In re Travelot Co.*, 286 B.R. 447, 455 (Bankr. S.D.Ga. 2002); *Council of Better Bus. Bureaus, Inc. v.*

Better Bus. Bureau, Inc., No. 99-CV-282 (HGMGJD), 1999 WL 288669, at *3 (N.D.N.Y. Mar. 30, 1999) (non-bankruptcy case; holding that non-exclusive trademark licensee needed licensor's consent for *de facto* assignment of its license via merger; citing *PPG Industries*); 3 *McCarthy on Trademarks and Unfair Competition* § 25.07[2], [3] (3d ed. 1996) ("[s]ince the licensor-trademark owner has the duty to control the quality of goods sold under its mark, it must have the right to pass upon the abilities of new potential licensees").

3. Exclusive IP licenses – Limited case law exists.

a. Patents – Consent is required. *In re Hernandez*, 285 B.R. 435, 439-40 (Bankr. D. Ariz. 2002) (holding that federal patent law requires the licensor's consent to assign an exclusive patent license under Section 365(c)).

b. Copyrights – Consent issue is mixed. *Gardner v. Nike, Inc.*, 279 F.3d 774, 777-78 (9th Cir. 2002) (federal copyright law prohibits assignment of exclusive copyright license without licensor's permission). *But see In re Valley Media, Inc.*, 279 B.R. 105, 135 (Bankr. D. Del. 2002) (exclusive copyright licenses grant the licensee a "freely transferable" property right); *In re Buildnet, Inc.*, 2002 WL 31103235, *5 (Bankr. M.D.N.C. 2002); *In re Golden Books Family Entertainment, Inc.*, 269 B.R. 311, 316-20 (Bankr. D. Del. 2001) (allowing debtor to assume and assign exclusive copyright license in bankruptcy; noting that copyright law distinguishes between exclusive and non-exclusive licensees and grants *all* rights of ownership to former; disagreeing with lower court *Gardner* decision and adopting *Patient Education Media*); *In re Patient Education Media*, 210; B.R. 237; 240 (Bankr. S.D.N.Y. 1997) (analyzing non-exclusive copyright license, but stating that exclusive licensee may freely transfer its rights under such license).

c. Trademarks – Consent is required. *Tap Publ'ns, Inc. v. Chinese Yellow Pages, (New York), Inc.*, 925 F.Supp. 212, 218 (S.D.N.Y. 1996) (exclusive trademark license presumed unassignable unless terms explicitly indicate otherwise).

D. Assumption of IP Licenses

1. Consent required – The "hypothetical test" follows the plain language of Section 365(c), which requires consent for trustee to "assume or assign" an executory contract. *Cinicola v. Scharffenberger*, 248 F.3d 110, 121 (3rd Cir. 2001); *In re Catapult Entertainment*, 165 F.3d 747 (9th Cir. 1999); *Matter of West Electrics, Inc.*, 852 F.2d 79. 82-83 (3rd Cir. 1988) (military supply contract), *In re James Cable Partners*, 27 F.3d 534, (11th Cir. 1994); *In re Andrews*, 80 F.3d 906, 915 (4th Cir. 1996) (non-competition agreement); *In re Catron*, 158 B.R. 629, 635-36 (E.D. Va. 1993), (partnership agreement), *aff'd*, 25 F.3d 1038 (4th Cir. 1994); *In re Valley Media, Inc.*, 279 B.R. 105, 136 (Bankr. D. Del. 2002); *In re Travelot Co.*, 286 B.R. 447, 454 (Bankr. S.D.Ga. 2002); *In re Hernandez*, 285 B.R. 435, 440 (Bankr. D.Ariz. 2002); *In re Neuhoff Farms, Inc.*, 258 B.R. 343, 350-51 (Bankr. E.D. N.C. 2000) (hog supply contract); *In re Access Beyond Technologies, Inc.*, 237 B.R. 32, 48-49 (Bankr. D. Del. 1999); *In re Techdyn Systems Corp.*, 235 B.R. 857, 862-64 (Bankr. E.D. Tex. 1999).

2. Consent not required — The "actual test" follows legislative intent and endorses substance over form; the debtor-in-possession is still the same functional entity, and consent is not required for assumption. *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489, 492-94 (1st Cir. 1997), *cert. denied*, 521 U.S. 1120 (1997); *Summit Inv. & Development Corp v. Leroux*, 69 F.3d 608, 612-14 (1st Cir. 1995); *RCC Technology Corp. v. Sunterra Corp.*, 287 B.R. 864, 865-66 (D.Md. 2003) (applying actual test and claiming that Fourth Circuit had not addressed issue, despite *In re Catron* and *In re Andrews*); (partnership agreement); *In re Leroux*, 1997 WL 375677, *9 (Bankr. D. Mass. 1997); *In re Am Ship Bldg. Co.*, 164 B.R. 358, 362-63 (Bankr. M.D. Fla. 1994) (government shipbuilding contract); *Texaco Inc. v. Louisiana Land and Expl. Co.*, 136 B.R. 658, 668-71 (M.D. La. 1992) (mineral lease contracts); *In re Cardinal Industries, Inc.*, 116 B.R. 964, 979 (Bankr. S.D. Ohio 1990) (personal services contract).

IV. Licensor Goes Bankrupt: Section 365(n)

A. Section 365(n) Protection

1. The Bankruptcy Code provides certain protections for non-debtor licensees of intellectual property. In *Lubrizol Enterprises Inc. v. Richmond Metal Finishers Inc.*, 756 F.2d 1043, 1048 (4th Cir. 1985), *cert. denied*, 475 U.S. 1057 (1986), the Fourth Circuit upheld a technology licensor's rejection of a license as properly following the law, despite the "serious burden" it caused to the licensee. In reaction to *Lubrizol*, and to protect all similarly situated licensees, Congress enacted the Intellectual Property

Bankruptcy Protection Act of 1988 to add Section 365(n), 11 U.S.C. §365(n), to the Bankruptcy Code.

2. Section 365(n) provides that if the trustee rejects an executory contract for intellectual property, the licensee may:

   a. treat the contract as terminated if such rejection amounts to a terminable breach; or

   b. retain its rights to the licensed IP (including any rights of exclusivity, but no other rights of specific performance) under such contract and any agreement supplementary thereto, provided that royalties are paid.

B. Section 365(n) Issues

1. Not all IP is "intellectual property" under Section 365(n). The definition in 11 U.S.C. §101(35A) comprises: trade secrets, patents, patent applications, plant varieties, copyrights and mask works protected under 17 U.S.C. §905.

2. Trademarks are not protected by 365(n). *In re H&Q Global Holdings, Inc.*, 290 B.R. 507, 512-13 (Bankr. D. Del. 2003); *In re Centura Software Corp.*, 281 B.R. 660, 669-75 (Bankr. N.D. Cal. 2002) (holding that rejected trademark licensee had no right to continued use of the trademark). *But see In re Matusalem*, 158 B.R. 514 (Bankr. S.D. Fla. 1993) (refusing to authorize rejection of trademark license, when debtor gained no economic benefit, rejection was motivated by bad faith and would result in huge claim against the estate).

3. Other IP is not included. The definition of "intellectual property" for Section 365(n), set forth in 11 U.S.C. §101(35A), does not include rights of publicity, unpatented inventions that are not trade secrets, raw data, and other IP-related rights. *See Cloyd v. GRP Records*, 238 B.R. 328, 335 (Bankr. E.D. Mich. 1999) (noting that individual covered by recording contract is not "intellectual property" under Bankruptcy Code).

4. Future IP is not included. Meanwhile, this unprotected matter can represent most of the license's value. For example, for a license to real-time national news footage, Section 365(n) allows the licensee to keep its pre-existing content, which would quickly become stale, and the licensee would receive no future news footage after the licensor's bankruptcy date. *See FutureSource LLC v. Reuters Ltd.*, 312 F.3d 281, 286 (7th Cir. 2002).

5. Contingent licenses are not covered. The license agreement must be valid and effective prior to the licensor's bankruptcy to merit Bankruptcy Code § 365(n) protection. In *In re Storm Technology Inc.*, 260 B.R. 152, 157 (Bankr. N.D. Cal. 2001), the court held that a "springing" patent license – it was to "spring" into effect if the licensor did not repay a corporate note on time – was not covered by Bankruptcy Code § 365(n). The licensor had declared bankruptcy before the note's maturity date, and therefore, the licensee had only a contingent right to a license, not an actual license, at that time.

C. Impact of § 363(f) upon Section 365(n)

1. Recent case law regarding leases suggests by analogy that non-debtor licensees must duly and timely object to any attempted sale of the licensed IP by the debtor "free and clear of any interest" under Section 363(f). *See Precision Industries, Inc. v. Qualitech Steel SBQ*, 327 F.3d 537 (7th Cir. 2003) (chapter 11 debtor can sell real estate free and clear of existing leases, regardless of the lessee's protection provided under 11 U.S.C. § 365(h); parties did not dispute that criteria of Section 363(f) were met).

2. An IP licensee's failure to object before the bankruptcy court to a § 363(f) sale may constitute "consent" to the sale for § 363(f) purposes. *FutureSource, LLC v. Reuters Ltd.*, 312 F.3d 281 (7th Cir. 2002), *cert. denied,* 123 S.Ct. 769 (2003). *But* see *In re Taylor*, 198 B.R. 142 (Bankr. D.S.C. 1996) (basing refusal to approve § 363 sale on view that Congress intended § 365 to be exclusive means for debtor to relieve itself of executory contract); *Solon Automated Services, Inc. v. Georgetown of Kettering, Ltd.*, 22 B.R. 312 (Bankr. S.D. Ohio 1982) (stating that "the protections afforded by 11 U.S.C. § 365 to parties entering into lease arrangements with a debtor may not be circumvented by use of Chapter 11 proceedings").

V. Privacy Issues – Customer Data

A. Value – Lists of current customers, potential customers, Internet users, donors (for charities), etc., are often an extremely valuable asset of a bankrupt company. Yet, for companies with an online presence, sales of customer information may violate their posted privacy policy.

B. State AG Actions

1. Egghead.com. *In re Egghead.com*, No. 01-32125-SFC-11 (Bankr. N.D. Cal. Sept. 21, 2001).

a. Egghead in Chapter 11 sought to sell customer information and other assets to buyer. Privacy policy stated: "We do not sell or rent our customer information to any outside party under any circumstances. We do not reveal your e-mail address or other personal information, except to complete transactions with our third party vendors."

b. The sale was structured to address privacy issues: buyer to purchase and operate entire web site; buyer to assume obligations of prior privacy policy; changes by buyer to policy will apply only to information obtained after notice of the policy change; all customers of debtor receive notice of sale and right to opt-out of information transfer.

c. Several state attorneys general objected to the sale, calling for an opt-in requirement. The bankruptcy court issued order overruling objection and approving the sale.

2. Toysmart. *FTC v. Toysmart.com, LLC*, 2000 WL 1523287 (D. Mass. 2000).

a. Toysmart ran into financial trouble and ceased operations in May 2000. Creditors filed an involuntary Chapter 11 case. Toysmart filed a motion to auction several assets, including customer data.

b. Toysmart had, since 1999, maintained privacy policy stating: "Personal information voluntarily submitted by visitors to our site, such as name, address, billing information and shopping preferences, is never shared with a third party. All information obtained by toysmart.com is used only to personalize your experience online" and "When you register with toysmart.com, you can rest assured that your information will never be shared with a third party." The company was also a licensee of TRUSTe.

c. The FTC sued Toysmart in federal district court in Boston alleging that the sale of data was an unfair or deceptive business practice violating the FTC Act and requesting an injunction against the sale.

d. FTC and Toysmart reached settlement agreement: Toysmart was permitted to sell its customer list as part of package of assets including entire Toysmart web- site. Toymart could sell only to an entity that was in a related market and that agreed to be its successor-in-interest as to customer information and to abide by

terms of the privacy policy. The buyer may change the privacy policy only after notifying consumers and obtaining their affirmative consent (opt-in).

e. State attorneys general filed objections in bankruptcy court to the data sale, and the court rejected the FTC settlement.

f. Toysmart withdrew customer data from the auction, and agreed in 2001 to destroy the customer list, in return for $50,000 from Buena Vista Internet Group – a Toysmart shareholder.

3. Living.com. *AG of Texas v. Poulin [trustee],* No. 0012522-FM (Bankr. W.D. Tex. Sept. 25, 2000).

a. Living.com filed Chapter 7 case in August 2000. Its privacy policy stated that "[L]iving.com does not sell, trade or rent your personal information to others without your consent. We may choose to do so in the future with trustworthy third parties, but you can tell us not to by sending a blank email message to never@living.com…"

b. The Texas Attorney General threatened legal action to protect consumers' data.

c. Living.com settled, and the agreement included a promise to destroy customers' personal financial data and to give customers notice and opt-out opportunity before selling other personal data.

4. Essential.com. *In re Essential.com, Inc.* No. 01-15339-WCH (Bankr. D. Mass. Aug. 7, 2001).

a. Essential.com in Chapter 11 sought to sell its customer list to two potential buyers. Its original privacy policy had stated that it did not sell, trade or rent personal information to others; the policy was changed shortly before Chapter 11 filing to allow for transfer of customer information to third parties acquiring all or part of its business.

b. The Massachusetts Attorney General filed objections, claiming unfair and deceptive trade practice under state law.

c. The court approved sale with stipulation that buyers would: notify customers of the transfer and indicate their own privacy policy; destroy the information of any customer who did not wish

to accept telecommunication service from the buyer; and not disclose customer information to third parties prior to the transfer of service, without the customer's affirmative consent.

5. eToys, Inc. Press Release, Office of the Attorney General, State of Texas, Cornyn Victorious in "eToys" Case-Privacy Protection Action Secures Rights of 3 Million Online Customers (May 18, 2001), available at http://www.oag.state.tx.us/newspubs/releases/2001/2001>05183toys2.htm.

   a. The Company filed a Chapter 11 case in March 2001.

   b. The Texas Attorney General filed objection to sale of customer list as part of the reorganized debtor's stock sale and proposed appointment of ombudsman to represent consumers.

The bankruptcy court overruled the objection and allowed the sale.

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