Showstoppers:
The effect of bankruptcy on intellectual property licenses

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The entertainment and publishing industries are built upon various intellectual property rights, principally copyright and trademark, but also the rights of privacy and publicity. Intellectual property assets have characteristics that set them apart from other classes of assets. They consist of rights of exclusive use that exist by virtue of the laws of particular jurisdictions, making them territorial, but some of them are the subject of international conventions that allow their extension to other jurisdictions, giving them potentially international scope. They are intangible and therefore inherently portable but their value derives from their physical embodiment in copyrighted works and trademarked products, all of which are commercialized in particular jurisdictions. Finally, they come into existence as exclusive rights, but their owners may exploit them by licensing them to others without losing their ownership rights or their own rights of use.

Taken together, these features of intellectual property tend to confound the process of marshaling assets in bankruptcy, since licensed intellectual property can be viewed as an asset of both the licensor and the licensee. Where the debtor is a licensor of intellectual property, it will want to maximize the value of the intellectual property by terminating unprofitable licenses, if this course of action is legally available, in order to enable it to enter into licenses on more profitable terms or to exploit the intellectual property itself. Where the debtor is a licensee, it will want to retain rights under any profitable licenses, either to continue its own exploitation or to assign to a purchaser. The question is how these two related assets – the intellectual property

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and the license granted under it – are treated in bankruptcy. The question becomes even more complicated when the license and the bankruptcy are international in scope.

1. The legal landscape in the United States

Under U.S. law, the filing of a voluntary petition for bankruptcy creates a bankruptcy estate consisting of all of the debtor's interests in property as of the filing, any proceeds of such property, and any additional interests in property that the debtor acquires in the case.[2] It also triggers an automatic stay, which prevents other parties from bringing actions to collect money from the debtor or to take possession or control over property of the estate.[3] Furthermore, clauses that purport to modify or terminate either contracts or the debtor's interest in property upon bankruptcy, so-called "*ipso facto* clauses," are not enforceable.[4]

In addition to protecting the debtor from actions by others, the filing of a voluntary petition relieves the debtor-in-possession of the obligation of performance under executory contracts entered into prior to the filing, allowing the trustee or debtor-in-possession to formulate a plan of reorganization. The trustee or debtor-in-possession may reject burdensome executory contracts[5] and may generally assume and assign executory contracts despite anti-assignment clauses in them.[6] In order to (i) assume or (ii) assume and assign a contract, the debtor must cure its defaults, compensate the other party for its actual losses, and provide adequate assurances of future performance.[7] An executory contract must be either assumed or rejected in its entirety[8]

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2 11 U.S.C. § 541.
3 11 U.S.C. § 362.
4 11 U.S.C. §§ 365(e)(1) and 541(c)(1).
5 11 U.S.C. § 365(a).
6 11 U.S.C. § 365(f)(1).
7 11 U.S.C. §§ 365(b)(1) and 365(f)(2).
8 *See Stewart Title Guar. Co. v. Old Republic Nat'l Title Ins. Co.*, 83 F.3d 735, 741 (5th Cir. 1996).

unless it contains separate agreements that are severable under applicable non-bankruptcy law.[9] Severability is "primarily a question of intention of the parties."[10]

The term "executory contract" is not defined in the Bankruptcy Code. The definition most commonly adopted by the courts is the "Countryman definition" by Professor Vernon Countryman, which defines an executory contract as one under which "the obligations of both the bankrupt and the other party to the contract are so unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other."[11]

2. Intellectual property licenses as executory contracts

Although there is some disagreement on the definition of executory contract, licenses of intellectual property typically contain mutual obligations sufficient to categorize them as executory, such as a licensee's continuing obligation to account for sales and pay royalties[12] and, in the case of a trademark license, to maintain the character and quality of the goods sold[13] or the reputation of the licensor[14] and a licensor's obligation to maintain the licensed property in effect.[15] Other executory obligations sometimes cited are the duties of indemnification[16] and product marking,[17] and the licensor's forbearance from selling products itself when it has granted an exclusive license.[18] Professor Countryman proposed that the grant of a patent license, even in the absence of any other express obligations, gives rise to an implicit warranty of validity,

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9 *Mirant Corp. v. Potomac Elec. Power Co.* (*In re Mirant*), No. 05-10038, 2006 WL 2034612, 2006 U.S. App. LEXIS 18129 (5th Cir. July 19, 2006) (*per curiam*).

10 *Holiday Homes v. Briley*, 122 A.2d 229, 232 (D.C. 1956).

11 Vernon Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973).

12 *In re Chipwich, Inc.,* 54 B.R. 427, 431 (Bankr. S.D.N.Y. 1985).

13 *In re Interstate Bakeries Corp.,* 447 B.R. 879, 886 (Bankr. W.D. Mo. 2011) *aff'd*, 690 F.3d 1069 (8th Cir. 2012).

14 *In re Rovine Corp.*, 6 B.R. 661, 665 (Bankr. W.D. Tenn. 1980).

15 *In re Chipwich, Inc.,* 54 B.R. at 430.

16 *Lubrizol Enters, Inc. v. Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.)*, 756 F.2d 1043, 1046 (4th Cir. 1085); *Chipwich,* 54 B.R. at 430.

17 *In re CFLC, Inc.*, 89 F.3d 673, 677 (9th Cir. 1996).

18 *Fenix Cattle Co. v. Silver (In re Select-A-Seat Corp.)*, 625 F.2d 290, 292 (9th Cir. 1980).

making nearly every patent license an executory contract.[19] Similarly, it has been held that, since a non-exclusive license is "a mere waiver of the right to sue" the licensee for infringement,[20] it includes an executory obligation on the licensor to refrain from such a suit.[21] By this reasoning, all non-exclusive licenses of intellectual property would necessarily be executory.

Notwithstanding the general rule that intellectual property licenses are executory contracts, they have sometimes been held to be non-executory. For example, in the case of *In re Stein and Day Inc.*,[22] where an author granted his publisher exclusive licenses to publish two books and the agreement was fully performed on the part of the author except for certain warranties, such as non-infringement, and the books had been published over a decade earlier, the court held that the contracts were not executory as to the author and denied a motion to compel the debtor to assume or reject the contracts.[23]

A similar analysis fact pattern arose in the context of a trademark license in *In re Exide Technologies*.[24] In this case, the debtor, Exide Technologies, sought to reject a trademark license arising from the sale to EnerSys, over a decade previously, of substantially all of its industrial battery business. The manufacturing assets were sold outright but, since Exide wanted to be able to continue using the trademark outside the industrial battery business, it retained ownership of the trademark but granted EnerSys a perpetual, exclusive, royalty-free license to use the mark in connection with the transferred industrial battery business. In 2000, Exide sought to re-enter the industrial battery market. It negotiated with EnerSys for an early termination of its ten-year period of non-competition and acquired another battery company. It also sought to reacquire the

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19 Vernon Countryman, *Executory Contracts in Bankruptcy: Part II*, 57 MINN. L. REV. 479, 501-502 (1974).
20 *De Forest Radio Tel. Co. v. United States*, 273 U.S. 236, 242 (1927) (quoting *Robinson on Patents* §§ 806, 808).
21 *CFLC*, 89 F.3d at 677.
22 81 B.R. 263 (Bankr. S.D.N.Y. 1988).
23 *Id.* at 266.
24 607 F.3d 957 (3d Cir. 2010), *as amended* (June 24, 2010), *cert. denied*, 131 S. Ct. 1470 (U.S. 2011).

trademark from EnerSys but EnerSys refused. After facing direct competition for two years from EnerSys, which was selling Exide-branded batteries, Exide filed for Chapter 11 protection and obtained permission of the bankruptcy court to reject the Exide trademark license. After the decision was affirmed by a memorandum order of the district court, EnerSys appealed to the Third Circuit Court of Appeals, arguing that the license agreement was not executory and that rejection of the contract failed to terminate its license rights.

The majority opinion held that the license agreement was not an executory contract, notwithstanding the obligations imposed on EnerSys not to use the mark outside the industrial battery business, to maintain the licensor's quality standards, and to provide indemnification and further assurances. The Third Circuit found that the restriction on the licensee's use was a non-material condition subsequent, that the licensor had not provided the licensee with any quality standards, that the warranty related to representations and warranties under the asset purchase agreement had expired eight years earlier, and that there was no evidence that any further assurances arising from the asset purchase transaction were required.[25]

Both *Stein and Day* and *Exide* indicate that when a license agreement looks more like a sale than a true license, a court may be more inclined to treat it as a non-executory contract in order to avoid an inequitable result. But the *Exide* case also opened the door to a more fundamental shift in the treatment of intellectual property licenses in bankruptcy. Judge Ambro concurred in the *Exide* result but argued that the district court had erred in holding that rejection of the trademark license terminated EnerSys's rights under the agreement. His argument was recently adopted by the court in Seventh Circuit Court of Appeals in *Sunbeam Products, Inc. v.*

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[25] *Exide Techs.*, 607 F.3d at 963-64. *Cf. In re Interstate Bakeries Corp.,* 447 B.R. 879, 886 (Bankr. W.D. Mo. 2011) *aff'd*, 690 F.3d 1069 (8th Cir. 2012) (finding a perpetual, royalty-free, exclusive license granted in connection with the sale of a business in a portion of the territory covered by the trademark to be an executory agreement and distinguishing Exide on the grounds that the agreement contained substantive quality control standards).

Chicago American Manufacturing, LLC,[26] which is discussed below in the context of the effect of rejection of license agreements by debtor licensors.

3. The debtor as licensor

As noted above, a debtor licensor may either assume or reject a license agreement that qualifies as an executory contract. In order to assume the license agreement, the debtor must cure its defaults, compensate the licensee for its actual losses, and provide the licensee with adequate assurances of future performance by the debtor or, if the license agreement is assigned, by a prospective assignee.[27] Although the option of assumption and assignment may be restricted for debtor licensees, as discussed below, a debtor licensor may generally assume and assign an intellectual property license even if the terms of the agreement prohibit it from doing so.[28]

3.1. Rejection under *Lubrizol*

The situation is much murkier when it comes to the *effect* of rejection of an intellectual property license. In the *Lubrizol* case, the debtor had licensed technology for a metal process to Lubrizol on a non-exclusive basis a little over a year before filing its petition for bankruptcy. The bankruptcy court approved the rejection of the technology license as an executory contract[29] and Lubrizol appealed to the district court, which reversed on the grounds that the contract was not executory and that rejection could not reasonably be expected to benefit the bankrupt debtor substantially, based partly on the assumption that rejection of the contract would not deprive Lubrizol of all its rights to the technology.[30]

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[26] 686 F.3d 372 (7th Cir. 2012).
[27] 11 U.S.C. § 365(b)(1).
[28] 11 U.S.C. § 365(f)(2).
[29] *In re Richmond Metal Finishers, Inc.*, 34 B.R. 521, 526 (Bankr. E.D. Va. 1983).
[30] *In re Richmond Metal Finishers, Inc.*, 38 B.R. 341, 345 (E.D. Va. 1984).

On appeal from the district court ruling, the Fourth Circuit Court of Appeals held that the debtor's obligation under a most-favored-licensee clause, as well as the obligations to notify, defend and indemnify the licensee against possible suits, made the license agreement an executory contract and that rejection did in fact terminate Lubrizol's rights to use the technology.[31] The decision was based upon the well-established proposition that the non-debtor party to an executory contract is not entitled to specific performance from the debtor following rejection.[32] Framing the issue in this way, however, treats the grant of license as if it were a stream of goods to be delivered rather than a promise of forbearance from suing for infringement during the license term.

The Fourth Circuit acknowledged the harsh effect that its ruling would have on the licensee, noting that allowing rejection in such circumstances could have "a general chilling effect upon the willingness of such parties to contract at all with businesses in possible financial difficulty."[33] Nevertheless, it concluded that the bankruptcy law did not allow courts to alter the result based upon equitable considerations and added that it was in the power of Congress to ameliorate the consequences if it desired to do so, as it had with respect to collective bargaining contracts.[34]

The same reasoning was applied in the context of a trademark license in *In re Chipwich, Inc*.[35] In that case, the debtor had granted exclusive licenses to Farmland Dairies to produce eggnog, flavored milk and a dairy shake product under the trademark CHIPWICH in exchange for one-time license fees totaling $90,000 and continuing royalties. The terms ran for 50 years under the first license and 99 years under the second, with an option for Farmland to renew for

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31 *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985).
32 *See N.L.R.B. v. Bildisco and Bildisco*, 465 U.S. 513, 531 (1984).
33 *Lubrizol,* 756 F.2d at 1048.
34 *Id.*
35 *Chipwich,* 54 B.R. 427.

another 99 years. The court rejected Farmland's argument that the license agreements were non-executory and approved the debtor's rejection of the license agreements, finding that it was in the debtor's best interests to terminate Farmland's licenses and seek more lucrative contracts with other licensees.[36]

3.2. Congressional response to *Lubrizol*: § 365(n)

In response to the *Lubrizol* decision, Congress enacted the Intellectual Property Protection Act of 1988, which created statutory protections for intellectual property licensees whose licenses were rejected by a debtor-licensor. These protections, which were codified as Section 365(n) of the Bankruptcy Code, apply both before and after rejection by the debtor.

Prior to rejection, on receiving a written request from the licensee, the debtor-licensor must perform the license agreement and provide the licensee with access to the licensed intellectual property in accordance with the terms of the agreement, and may not interfere with the contractual rights of the licensee to such intellectual property.[37]

Upon rejection by the debtor-licensor, the licensee has two options. It may treat the license agreement as terminated, in which case any claim for damages would be treated as a general unsecured claim against the bankruptcy estate.[38] Alternatively, the licensee may elect to retain its existing rights in the licensed intellectual property.[39] In the latter case, the licensee must continue to make royalty payments[40] and waive any right of set-off it may have under the agreement and any administrative claim allowable under Section 503(b) of the Bankruptcy Code

36 *Id.* at 431.
37 11 U.S.C. § 365(n)(4).
38 11 U.S.C. § 365(n)(1)(A).
39 11 U.S.C. § 365(n)(1)(B).
40 11 U.S.C. § 365(n)(2)(B).

arising from the performance of such contract.[41] The licensor-debtor is relieved of any further obligations, other than allowing the licensee to exercise rights under the license agreement.

3.3. Treatment of trademark licenses in bankruptcy

The protections granted under § 365(n) apply only to licensees of "intellectual property" as defined in the Bankruptcy Code. The definition includes (i) trade secrets, (ii) inventions, processes, designs, or plants protected under U.S. patent law, (iii) patent applications, (iv) plant varieties, and (v) works of authorship protected under U.S. copyright law, or mask works (used in the production of semiconductor chip products).[42] Conspicuously missing from this list are trademarks and service marks as well as the right of privacy and publicity. In enacting § 365(n), Congress explained the omission of trademarks and service marks as follows:

> [T]he bill does not address the rejection of executory trademark, trade name or service mark licenses by debtor-licensors. While such rejection is of concern because of the interpretation of section 365 by the Lubrizol court and others ..., such contracts raise issues beyond the scope of this legislation. In particular, trademark, trade name and service mark licensing relationships depend to a large extent on control of the quality of the products or services sold by the licensee. Since these matters could not be addressed without more extensive study, it was determined to postpone congressional action in this area and to allow the development of equitable treatment of this situation by bankruptcy courts.[43]

Notwithstanding this statement of Congressional intent, courts have generally reasoned by negative inference that the omission of trademarks from the definition of intellectual property means that Congress intended *Lubrizol*'s holding to control when a debtor-licensor rejects a trademark license.[44] Judge Ambro's concurrence in *Exide*, however, focused judicial attention

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41 11 U.S.C. § 365(n)(2)(C)(i), (ii).

42 11 U.S.C. § 101(35A).

43 S. REP. NO. 100-505, at 5 (1988), *reprinted in* 1998 U.S.C.C.A.N. at 3204.

44 *In re Old Carco LLC*, 406 B.R. 180, 211 (Bankr. S.D.N.Y. 2009) (trademarks are not "intellectual property" under the Bankruptcy Code, so "rejection of licenses by licensor deprives licensee of right to use trademark") (internal citations omitted); *In re HQ Global Holdings, Inc.*, 290 B.R. 507, 513 (Bankr. D. Del. 2003) ("[S]ince the Bankruptcy Code does not include trademarks in its protected class of intellectual property, *Lubrizol* controls and the Franchisees' right to use the trademarks stops on rejection").

on the extensive scholarly criticism that followed the *Lubrizol* decision, [45] and argued that by allowing debtor-licensors to revoke licensed rights that it bargained away, *Lubrizol* confuses rejection with termination, which "makes bankruptcy more a sword than a shield, putting debtor-licensors in a catbird seat they often do not deserve."[46]

3.4. Rejection under *Sunbeam*

The argument planted by Judge Ambro in *Exide* came to full flower in *Sunbeam Products, Inc. v. Chicago American Manufacturing*, decided July 9, 2012 by the Seventh Circuit Court of Appeals.[47] The contract at issue was a trademark license not protected under § 365(n) and the facts of the case seem designed to illustrate the danger contemplated by both *Lubrizol* and *Chipwich* – that allowing the termination of license agreements in bankruptcy could have "a general chilling effect" upon the willingness of prospective licensees to contract at all with financially troubled businesses.[48] The debtor, Lakewood Engineering & Manufacturing Co., manufactured and sold a variety of products, including box fans. It was losing money on its sales of box fans and so contracted with Chicago American Manufacturing (CAM) to produce 1.2 million box fans under Lakewood's patent and authorized CAM to put Lakewood's trademarks on the finished box fans for shipment to retailers on orders from Lakewood. In view of Lakewood's financial situation, CAM was concerned about recouping the cost of gearing up for production and so negotiated the right to sell the trademarked box fans for its own account if Lakewood failed to purchase them.

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45 *See, e.g.*, Michael T. Andrew, *Executory Contracts Revisited: A Reply to Professor Westbrook*, 62 U. COLO. L. REV. 1, 11 (1991); Jay Lawrence Westbrook, *The Commission's Recommendations Concerning the Treatment of Bankruptcy Contracts*, 5 AM. BANKR. INST. L. REV. 463, 470–72 (1997); Douglas G. Baird, ELEMENTS OF BANKRUPTCY 130–40 & n.10 (4th ed. 2006).

46 *In re Exide Techs.,* 607 F.3d at 967-68 (Concurrence by Judge Ambro).

47 686 F.3d 372 (7th Cir. 2012).

48 *Lubrizol*, 756 F.2d at 1048; *Chipwich,* 54 B.R. at 431 (quoting *Lubrizol*).

Three months after executing the contract with CAM, Lakewood was put into bankruptcy by its creditors. Sunbeam Products bought Lakewood's assets, including its patents and trademarks, but did not want to buy the box fans manufactured by CAM and did not want CAM to sell them in competition with its own products. Lakewood's trustee rejected the executory portion of the agreement with CAM and brought an adversary action alleging patent and trademark infringement by CAM. The bankruptcy judge cited Judge Ambro's concurrence in *Exide* but, rather than reaching the issue of whether rejection of a trademark license ends the licensee's right to use the trademark, decided to allow CAM to continue using the Lakewood marks "on equitable grounds."[49]

On appeal, the Seventh Circuit found the bankruptcy judge's reliance on equitable grounds untenable[50] but affirmed the judgment in favor of CAM on the grounds that the trustee's rejection of the trademark license did not terminate the trademark license. In so ruling, the Seventh Circuit relied on the Bankruptcy Code provision that provides that a rejection constitutes a breach of the contract, not a termination. The court explained that, outside of bankruptcy, a licensor's breach does not terminate a licensee's right to use the intellectual property and thus, by classifying a rejection as a breach, the Bankruptcy Code allows the other party's rights to remain in place if the debtor or trustee decides to reject an executory contract.[51] The court explicitly adopted Judge Ambro's argument and rejected the *Lubrizol* decision, noting that no other court of appeals had either agreed or disagreed with it since it was issued.[52] Since the opinion creates

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[49] *In re Lakewood Eng'g Mfg. Co., Inc.*, 459 B.R. 306, 345 (Bankr. N.D. Ill. 2011).
[50] *Sunbeam Prods., Inc. v. Chicago Am. Mfg., LLC*, 686 F.3d at 375-76.
[51] *Id.* at 376-77.
[52] *Id.* at 376.

a conflict among the federal circuits, it was circulated to all active judges on the circuit and none of them favored a hearing *en banc*.[53]

3.5. After *Sunbeam*

The reasoning of *Sunbeam* would appear to apply equally well to trademark licenses, licenses of copyrights and other intellectual property as defined in the Bankruptcy Code, and licenses granted under the rights of privacy and publicity. If so, and if the *Sunbeam* analysis prevails in the other circuits, it is not clear what will become of § 365(n), which was intended as a statutory overruling of *Lubrizol*. The language of the section is permissive. It states that the licensee "may" elect to treat the contract as terminated or to retain its rights to the intellectual property licensed under the contract but that it must then waive any set-off rights under the contract and any administrative claims. After *Sunbeam*, a non-debtor licensee may therefore have a third option. It may perhaps choose not to avail itself of its rights under § 365(n) and to retain not only the right to use the licensed intellectual property but also any contractual right of set-off that it may have.

4. The debtor as licensee

When the debtor is the licensee rather than the licensor, another special provision of the Bankruptcy Code comes into play. A debtor or trustee may normally assume executory contracts[54] and the debtor or trustee may normally assign executory contract rights to third parties notwithstanding contract provisions or applicable law prohibiting or restricting assignment.[55] But § 365(c) creates a narrow exception to these general rules:

> (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—

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[53] *Id.* at 378.
[54] 11 U.S.C. § 365(a).
[55] 11 U.S.C. § 365(f)(1).

> (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
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> (B) such party does not consent to such assumption or assignment, either as the debtor-in-possession or for the purpose of assigning them to a third party purchaser.

Sub-clause (B) does not require that the licensor consent to the assignment in the context of the bankruptcy. Where the license agreement itself permits assignment under certain conditions, the licensor is deemed to have consented to assignment within the bankruptcy in accordance with those conditions.[56]

The term "applicable law" is not defined in the Bankruptcy Code. It is interpreted as "any law applicable to a contract, other than bankruptcy law."[57] The assignability of licenses of rights arising under state law, such as privacy and publicity, will be subject to the law of the applicable state. Where the issue is the assignability of license rights under a copyright, patent or federal trademark, however, the courts will apply federal common law even when the parties have chosen the law of a state to govern the contract.[58] Although it has been established since *Erie v. Tompkins* that there is no federal general common law,[59] federal common law has nevertheless developed in particular areas "within which the policy of the law is so dominated by the sweep of federal statutes that legal relations which they affect must be deemed governed by federal law having its source in those statutes, rather than by local law…."[60] In the area of

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56 *In re Midway Airlines, Inc.*, 6 F.3d 492, 496 (7th Cir. 1993).

57 *In re XMH Corp.*, 647 F.3d 690, 695 (7th Cir. 2011).

58 *In re CFLC, Inc.*, 89 F.3d 673 (9th Cir. 1996) (patent); *In re Patient Educ. Media, Inc.*, 210 B.R. 237, 241 (Bankr. S.D.N.Y. 1997) (copyright); *In re Golden Books Family Entm't, Inc.*, 269 B.R. 311 (Bankr. D. Del. 2001) (copyright); *In re N.C.P. Mktg. Group, Inc.*, 337 B.R. 230 (D. Nev. 2005), *aff'd,* 279 Fed. App'x 561 (9th Cir. 2008), *cert. denied*, 129 S. Ct. 1577 (2009) (trademark); *In re XMH Corp.*, 647 F.3d 690, 695-696 (7th Cir. 2011) (trademark).

59 *Erie R. Co. v. Tomkins*, 304 U.S. 64, 78 (1938).

60 *Unarco Indus. Inc. v. Kelley Co.*, 465 F.2d 1303, 1306 (7th Cir. 1972), *cert. denied*, 410 U.S. 929 (1973) (federal law rather than state law applied to the issue of licensee estoppel in view of federal antitrust policy).

federally registered intellectual property rights, the federal policy of encouraging creation of inventions and original works of authorship by granting limited monopolies to inventors and authors has been held to bar the free assignability of patent licenses and copyright licenses, which would undermine the licensor's ability to control the identity of its licensees.[61]

Unlike the grant of rights under patent and copyright law, trademarks rights do not have a Constitutional basis and their purpose is not to encourage creativity in the naming of products, but rather to protect consumers from confusion about the source of the trademarked goods or services. Where the owner of a trademark chooses to license the mark for use by others, it must therefore exercise quality control of the goods or services sold under the mark or risk losing its rights in the mark.[62] The requirement that a licensor control the quality of the goods or services sold by its licensee has generally been taken to imply that trademark licenses are inherently non-assignable.[63] Indeed, where a trademark license failed to specify the governing law, and the facts might have supported the application of the laws of Washington State or Canada, the Seventh Circuit recently stated: "None of this matters, though, because as far as we've been able to determine, the universal rule is that trademark licenses are not assignable in the absence of a clause expressly authorizing assignment."[64]

4.1. The effect of exclusivity

The grant of an exclusive license in intellectual property is akin to assignment in that the licensor does not retain the right to exploit the property. Where the licensor does not retain a reversionary interest and fails to exercise any control over the licensee's use of the licensed property, as with the irrevocable exclusive trademark license in *Exide*, the license agreement

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61 *CFLC*, 89 F.3d at 679; *In re Patient Educ. Media, Inc.*, 210 B.R. at 243.
62 *XMH,* 647 F.3d at 695-96.
63 *Tap Publ'n, Inc. v. Chinese Yellow Pages (New York) Inc.*, 925 F. Supp. 212, 218 (S.D.N.Y 1996).
64 *XMH*, 647 F.3d at 695 (7th Cir. 2011).

may be treated as a *de facto* assignment. The result in *Exide* was that the agreement was held to be non-executory and not subject to rejection by the debtor licensor. [65] When the debtor is the licensee, it has been suggested that exclusivity may make the license agreement assignable in bankruptcy like other contracts, notwithstanding a non-assignment provision.[66] The precedent is somewhat ambiguous, however.

(a) <u>Copyright licenses</u>

Under the Copyright Act of 1909, ownership in copyrights was indivisible and copyright licenses, whether exclusive or non-exclusive, were not transferable by sale or sublicense without the express authorization of the licensor.[67] The 1976 Act eliminated the doctrine of indivisibility and added a definition of "transfer of copyright ownership" as:

> an assignment, mortgage, **exclusive license**, or any other conveyance, alienation, or hypothecation of a copyright or of any of the exclusive rights comprised in a copyright, whether or not it is limited in time or place of effect, but not including a nonexclusive license.[68]

The new definition has generally been interpreted to mean that exclusive copyright licenses are assignable in the absence of a contractual restriction.[69] The Ninth Circuit held in *Gardner v. Nike, Inc.*, however, that the 1976 Copyright Act merely extended to an exclusive licensee the "protections and remedies accorded to the copyright owner," including the right to sue in its own name, but not the right to assign the license without the licensor's consent.[70]

The *Gardner* case arose from a 1992 license agreement between Nike and Sony involving Nike's cartoon character MC Teach. In exchange for a fifteen percent royalty, Nike

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65 *Exide Techs.,* 607 F.3d at 964.
66 *Perlman v. Catapult Entm't, Inc. (In re Catapult Entm't, Inc.)*, 165 F.3d 747, 752 (9th Cir. 1999), *cert. dismissed*, 528 U.S. 924 (1999).
67 Melville B. Nimmer & David Nimmer, NIMMER ON COPYRIGHT § 10.01[C][4] (2009).
68 17 U.S.C. § 101 (emphasis supplied).
69 *Patient Educ. Media,* 210 B.R. 237, 243 (Bankr. S.D.N.Y. 1997) (dicta); *Golden Books Family Entm't,* 269 B.R. 311.
70 279 F.3d 774, 780 (9th Cir. 2002) (citing § 201(d)(2) of the 1976 Copyright Act).

granted Sony the exclusive, perpetual, worldwide right to use MC Teach in connection with phonograph records, in television programs and motion pictures using music from the records, and on educational materials and clothing. The agreement also stated that Nike would own the copyright in the licensed materials and that the materials would bear a notice of Nike's copyright. The agreement was silent with respect to Sony's right to assign the exclusive license.

In 1996, Sony assigned all of its rights in the exclusive license to Gardner in exchange for a share of the proceeds derived from use of the MC Teach character. Nike threatened legal action against Sony and Gardner and Gardner brought a declaratory judgment action seeking declaratory relief. The district court granted Nike's motion for summary judgment, finding that Sony could not assign the exclusive copyright license without the consent of Nike.

On appeal, the Ninth Circuit affirmed the district court's decision The court reasoned that the amendment of the definition of "transfer of ownership" in Section 101 must be read together with Section 201(d)(1), allowing the transfer of ownership, and 201(d)(2), which specifically permits the subdivision and separate ownership of the rights granted by copyright and states that "[t]he owner of any particular exclusive right is entitled, to the extent of that right, to all of the protection and remedies accorded to the copyright owner by this title."[71] Sony was thus entitled to sue in its own name for infringement of the licensed copyright but was not entitled to assign the license without Nike's consent. The court bolstered its conclusion with a discussion of policy considerations, citing the a copyright licensor's need to control the identity of licensees and to monitor the use of the copyright as "strong policy reasons" in favor of requiring the licensor's consent, adopting the reasoning used by the *CFLC* case in the context of a patent license.[72]

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[71] 17 U.S.C. § 201(d)(2).
[72] *Id.* at 780-81.

The *Gardner* decision has been severely criticized, however, in subsequent cases and scholarly commentary. In *In re Golden Books Family Entertainment, Inc.*, the debtor sought to assume and assign a licensing agreement relating to the character Madeleine. The bankruptcy court held that the license was exclusive rather than non-exclusive and that, because of the Copyright Act's inclusion of exclusive licenses in definition of transfer of ownership, the debtor could assign the license notwithstanding a contractual prohibition of assignment. It criticized the *Gardner* decision as being in contradiction to the leading cases and commentary[73] and concluded that including the right of assignment in the rights of an exclusive licensee is a more natural reading of the Copyright Act.[74] Subsequent cases have echoed this criticism.[75] It may noted that, under this line of authority, it would appear to be impossible for a copyright licensor to grant its licensee the right to bring infringement suits in the licensee's own name while retaining for itself the right to control the identity of the licensee in the event of the licensee's bankruptcy.

(b) Patent licenses

The statutory language used to support the free assignability of exclusive copyright licenses is not relevant to patents. Most cases addressing assignability have arisen in the context of non-exclusive licenses and some have expressly limited their holdings to this context, leaving open the possibility that exclusive patent licenses should be freely assignable in the absence of a contractual limitation.[76] One court that has examined the issue, however, has held that the analysis that applies to non-exclusive patent licenses applies equally to exclusive patent licenses, and that neither is assignable.[77]

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73 *In re Golden Books Family Entm't*, 269 B.R. 311 at 317.
74 *Id.* at 318.
75 *See Traicoff v. Digital Media, Inc.*, 439 F. Supp. 2d 872, 877-78 (S.D. Ind. 2006) (collecting authority).
76 *Perlman v. Catapult Entm't, Inc. (In re Catapult Entm't, Inc.)*, 165 F.3d 747, 752 (9th Cir. 1999), *cert. dismissed*, 528 U.S. 924 (1999).
77 *In re Hernandez*, 285 B.R. 435 (Bankr. D. Ariz. 2002).

(c) Trademark licenses

The underlying purpose of trademark protection is the protection of the public from confusion rather than rewarding inventors and artists for their creative contributions. But trademarks "are also used by trademark owners to protect themselves from unauthorized use of their mark, and they are used by trademark owners to preserve the value of their business name and products."[78] Since quality control is at the heart of a trademark license, the issue of controlling the identity of a licensee would be expected to weigh in favor of treating all trademark licenses as non-assignable. This appears to be the trend in recent cases.[79]

4.2. A note on nomenclature

The *XMH* case, which endorsed the position that trademark licenses are inherently not assignable, involved a contractual relationship that had begun as a trademark sublicense but had been converted into a services agreement without an explicit license. Since the substantive obligations of the parties were similar under the sublicense and the services agreement, the licensor argued that the service agreement should be construed as an implied sublicense which could not be assigned. The court rejected this argument, however, noting that the agreement expressly provided that, at the end of the license term, the trademark rights and trademarked goods reverted to the licensor, who assumed sole control over sales, pricing and production going forward. Under the circumstances, the parties' choice of the description "services agreement" rather than "trademark sublicense" rendered the agreement assignable.[80]

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78 *N.C.P. Mktg. Group*, 337 B.R. at 236.

79 *Id.; In re Wellington Vision, Inc.*, 364 B.R. 129, 136 (S.D. Fla. 2007) (inclusion of trademark license in franchise agreement rendered it unassignable); *Tap Publ'ns, Inc. v. Chinese Yellow Pages (New York) Inc.*, 925 F. Supp. at 218 (exclusive trademark license not assignable), *Miller v. Glenn Miller Prods., Inc.*, 454 F.3d 975, 988 (9th Cir. 2006) (*per curiam*); *XMH Corp.*, 647 F.3d at 695.

80 *XMH Corp.*, 647 F.3d at 697-98.

4.3. Effect of non-assignability

There is a split among the federal circuits on the effect of non-assignability on the ability of a debtor in bankruptcy to assume a contract. As stated above, Section 365(c) provides that an executory contract may not be assumed if applicable non-bankruptcy law excuses the counterparty from accepting performance from, or rendering performance to, an entity other than the debtor, and such party does not consent to such assumption or assignment. In order to assign an executory contract, the contract must first be assumed. The Ninth Circuit applies the "hypothetical" test, which allows the debtor to assume an executory contract only if, hypothetically, it could assign that contract to a third party, even if the debtor does not actually intend to assign the contract. [81] This test has also been adopted by Third Circuit,[82] the Fourth Circuit[83] and, apparently, the Eleventh Circuit.[84] The "actual test" prevents assumption if the debtor actually intends to assign the contract that is non-assignable pursuant to applicable non-bankruptcy law and the counterparty does not consent. This prevents a licensor from being forced to accept performance from a party other than the debtor with whom it originally contracted. This test is applied by the courts of appeal in the First Circuit[85] and the Fifth Circuit[86] and has also been applied by bankruptcy courts in the Sixth Circuit[87] and the Eighth Circuit.[88]

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81 *Catapult Entm't,*165 F.3d at 749-50.

82 *Cinicola v. Scharfggenberger*, 248 F.3d 110, 121 (3rd Cir. 2001).

83 *In re Sunterra Corp.*, 361 F.3d 257, 266-67 (4th Cir. 2004).

84 *In re James Cable Partners, L.P.*, 27 F.3d 534 (11th Cir. 1994), *rehearing en banc denied*, 38 F.3d 575 (11th Cir. 1994).

85 *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489, 493 (1st Cir. 1997), *cert. denied,* 521 U.S. 1120 (1997).

86 *Bonneville Power Admin. v. Mirant Corp* (*In re Mirant Corp.*), 440 F.3d 238, 249 (5th Cir. 2006).

87 *In re Cardinal Indus., Inc.*, 116 B.R. 964, 979 (Bankr. S.D. Ohio 1990).

88 *In re GP Express Airlines, Inc.*, 200 B.R. 222, 232 (Bankr. D. Neb. 1996).

The Bankruptcy Court for the Southern District of New York developed a third approach in its 2005 decision in *In re Footstar, Inc.*[89] It is based on a new reading of the Bankruptcy Code which distinguishes between references to the trustee and the debtor or debtor-in-possession. Under the *Footstar* test of applying the plain language, Section 365(c) only applies with respect to the trustee's assumption or assignment of an executory license agreement. The debtor-in-possession may therefore assume such contracts.

5. Implications for cross-border bankruptcy proceedings

In order to promote a uniform and coordinated legal regime for cross-border insolvency cases, the U.S. adopted the Model Law on Cross-Border Insolvency promulgated by the United Nations Commission on International Trade Law ("UNCITRAL") in a new Chapter 15 added to the Bankruptcy Code by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. Because of the UNCITRAL source for Chapter 15, the U.S. interpretation must be coordinated with the interpretation given by other countries that have adopted it as internal law.

5.1. <u>Procedural harmonization</u>

Chapter 15 is intended to provide effective mechanisms for dealing with insolvency cases in which debtors, assets, claimants, and other parties involved are located in more than one country. It permits the representative of a debtor who is subject to a primary proceeding outside the United States to bring an ancillary proceeding in the United States. Recognition of a foreign main proceeding activates the automatic stay and other provisions of the Bankruptcy Code within the United States. The U.S. court may issue preliminary relief as soon as the petition for recognition is filed.[90] The law requires court and estate representatives to "cooperate to the maximum extent possible" with foreign courts and foreign representatives and authorizes direct

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89 *In re Footstar, Inc.*, 323 B.R. 566, 570-74 (Bankr. S.D.N.Y. 2005).
90 11 U.S.C. § 1519.

communication among the U.S. court, authorized estate representatives, the foreign courts and foreign representatives.[91] In addition, the U.S. court is directed to "grant comity or cooperation to the foreign representative"[92]

5.2. The public policy exception

In general, Chapter 15 requires the recognition of foreign proceedings and the enforcement of foreign judgments in the ancillary U.S. proceeding. This requirement is limited, however, by a public policy exception:

> Nothing in this chapter prevents the court from refusing to take an action governed by this chapter if the action would be *manifestly* contrary to the public policy of the United States.[93]

The use of the word "manifestly" in the formulation of the exception makes the exception a narrow one. It has been held to be triggered when application of the foreign decision would authorize the foreign representative to undertake electronic surveillance that would violate Federal criminal law[94] and when recognition of a foreign proceeding would effectively reward a creditor for violating the automatic stay in a prior U.S. proceeding to which it was a party.[95] It has been held not to apply, however, where the foreign decision deprives U.S. claimants of their Constitutional right to a jury trial of their product liability claims.[96]

5.3. Substantive dissonance

A disparity in the treatment of intellectual property licenses under the bankruptcy laws of the United States and Germany has led to another dispute over the public policy exception with respect to the recognition of foreign judgments under Chapter 15 in *In re Qimonda*.[97] Qimonda

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91 11 U.S.C. §§ 1525–1527.
92 11 U.S.C. § 1509(b)(3).
93 11 U.S.C. § 1506 (emphasis supplied).
94 *In re Toft*, 453 B.R. 186 (Bankr. S.D.N.Y. 2011).
95 *In re Gold & Honey, Ltd.*, 410 B.R. 357 (Bankr. E.D.N.Y. 2009).
96 *In re Ephedra Products Liab. Litig.*, 349 B.R. 333 (S.D.N.Y. 2006).
97 *In re Qimonda AG*, No. 09-14766, 2009 WL 4060083 (Bankr. E.D. Va. Nov. 19, 2009), *aff'd in part and*

was a leading German manufacturer of semiconductor chips who had entered into cross-licenses of thousands of patents. In January 2009, Qimonda commenced insolvency proceedings in Munich, Germany, which automatically rendered all of Qimonda's executory contracts unenforceable, subject to the debtor's right under the German Insolvency Code, § 103, to confirm nonperformance or to elect performance. Under German law, unenforceability means that the right of intellectual property licensees to exploit the licensed property is terminated, leaving the licensee with an unsecured claim against the bankrupt estate. The effect is similar to rejection as interpreted by *Lubrizol*.

In an ancillary proceeding filed in U.S., the bankruptcy court issued an order making the entirety of 11 U.S.C. § 365 applicable to the proceeding, including § 365(n), which allows licensees of the debtor's intellectual property to retain their licenses under certain conditions. When the foreign representative attempted to confirm nonperformance of patent licensing agreements pursuant to the German Insolvency Code, the licensees objected, asserting their rights under § 365(n) to continue exercising its rights under the licensing agreements notwithstanding the debtor's rejection in bankruptcy. After the bankruptcy court initially granted the foreign representative's motion to strike the reference to § 365(n) as contrary to German law and procedure, the case was appealed to the district court, which remanded the case to the bankruptcy court for further consideration of whether denial of the licensee's rights under § 365(n) of the U.S. Bankruptcy Code.

On remand, the bankruptcy court held that the balancing of the interests of parties weighed in favor of making Section 365(n) applicable to the administration of the debtor's U.S. patents and that limiting the applicability of § 365(n) was manifestly contrary to the public

remanded in part, 433 B.R. 547 (E.D. Va. 2010), *on remand*, 462 B.R. 165 (Bankr. E.D. Va. 2011), *cert. granted*, 470 B.R. 374 (E.D. Va. 2012).

policy of the United States. The foreign representative appealed and, on May 7, 2012, the district court certified the bankruptcy court's order for direct appeal to the Fourth Circuit Court of Appeals.[98] On October 10, 2012, the U.S. Justice Department submitted an amicus brief arguing that § 365(n) is irrelevant to the ancillary proceeding before the U.S. bankruptcy court and that the effectiveness of the action of the German insolvency proceeding could be settled later if Qimonda were to bring an infringement suit against the licensees under the U.S. patents included in cross-license agreements.

6. Conclusion

Licenses of intellectual property serve two fundamental contractual expectations: the licensor expects to be able to exercise control on the identity and behavior of the licensee with respect to its unique property and the licensee expects to be able to build a business by exploiting the same property. To the extent that a bankruptcy proceeding allows a licensor to terminate license rights or enables a licensee to assign the agreement beyond or in violation of the terms of the contract, it frustrates one of these expectations. Recent cases such as *Exide*, *XMH* and *Sunbeam* suggest a certain judicial antipathy toward such a result. As the court in *Sunbeam* puts it, "nothing about this process [of rejection of executory contracts] implies that any rights of the other contracting party have been vaporized," comparing the rejection of a license to the rejection of a lease, which does not end the tenant's right of possession.[99] At its core, this position appears to reflect a judgment on the fairness of the bankruptcy process, exemplified in Judge Ambro's observation that treating rejection of a license as a termination of licensed rights "put[s] debtor-licensors in a catbird seat they often do not deserve."[100] This judgment may have its roots in the basic principle of *pacta sunt servanda* in that it disfavors the use of bankruptcy

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98 *Qimonda AG*, 470 B.R. at 390 (granting certification to the Fourth Circuit Court of Appeals directly).
99 *Sunbeam Prods.*, 686 F.3d at 377.
100 *Exide Techs.,* 607 F.3d at 967-68 (Concurrence by Judge Ambro).

proceedings to rewrite the debtor's contracts except as necessary to shield it from affirmative executory obligations and the claims of creditors.[101]

The one notable exception to this overall picture is the treatment of exclusive licenses of copyright, where the statutory definition of "transfer of ownership" may deprive the licensor of the right to control the identity of its licensee in the event of the licensee\s bankruptcy. This exception will not be applicable in bankruptcies in the Ninth Circuit, however, unless the *Gardner* decision is overturned.

The implications of the recent developments for international disputes such as *Qimonda* are not yet clear. The public policy exception may be invoked "only under exceptional circumstances concerning matters of fundamental importance."[102] Prior to *Qimonda*, the precedents dealt with procedural remedies that were held to contravene fundamental public policy concerns of the United States. *Sunbeam* suggests that a bankruptcy process that terminates licensed rights is inherently inequitable but it does so in the context of interpreting the U.S. Bankruptcy Code. Given the continuing split of judicial authority in the U.S. and Congress's failure to deal with trademark licenses in § 365(n), a judicial rejection of *Lubrizol* cannot by itself support an argument that Germany's insolvency procedure violates the fundamental public policy of the United States.

Under the guidelines of the district court in *Qimonda*, the public policy exception may apply where a requested action "would impinge severely a U.S. constitutional or statutory right."[103] This more relaxed standard opens the door to a wider understanding of public policy, such as was enunciated in the legislative history of § 365(n). The ultimate question to be

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101 This principle appears in the contract clause, article I, § 10, cl. 1 of the U.S. Constitution, prohibiting the states from passing any law impairing the obligation of contracts.

102 349 B.R. at 336.

103 433 B.R. at 570.

answered in the appeal of *Qimonda* is whether substantive differences in the treatment of debtors and creditors, such as those reflected by § 365(n) of the U.S. Bankruptcy Code and § 103 of the German Insolvency Code, are enough to trigger the public policy exception. If so, then disputes such as *Qimonda* are likely to recur unless and until there is harmonization of substantive bankruptcy law.

Statutes and Cases

Federal Acts*

- 11 U.S.C. § 365

Cases*

- *Gardner v. Nike, Inc.*, 279 F.3d 774 (9th Cir. 2002)
- *In re CFLC, Inc.*, 89 F.3d 673 (9th Cir. 1996)
- *In re Chipwich, Inc.,* 54 B.R. 427 (Bankr. S.D.N.Y. 1985)
- *In re Exide Techs.,* 607 F.3d 957 (3d Cir. 2010), *as amended* (June 24, 2010)
- *In re Golden Books Family Entm't*, 269 B.R. 311 (Bankr. D. Del. 2001).
- *In re N.C.P. Mktg. Group, Inc.*, 337 B.R. 230 (D. Nev. 2005)
- *In re Old Carco LLC*, 406 B.R. 180 (Bankr. S.D.N.Y. 2009)
- *In re Patient Educ. Media, Inc.*, 210 B.R. 237 (Bankr. S.D.N.Y. 1997)
- *In re Qimonda*, 470 B.R. 374 (E.D. Va. 2012)
- *In re XMH Corp.*, 647 F.3d 690 (7th Cir. 2011)
- *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985)
- *Sunbeam Prods., Inc. v. Chicago Am. Mfg., LLC*, 686 F.3d 372 (7th Cir. 2012)
- *Traicoff v. Digital Media, Inc.*, 439 F. Supp. 2d 872 (S.D. Ind. 2006)

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