

The Impact of Bankruptcy on IP Litigation and Licensing

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The recent financial downturn has resulted in an explosion of corporate bankruptcy filings. Through December of 2009, there have been 60,530 business bankruptcy filings—a 41% year over year increase from 2008, and more than three times the number of cases filed 2006.² In the present economic environment, the possibility that a company’s intellectual property (“IP”) litigation or licensing activities will be impacted by another party’s bankruptcy is much more likely that it was even three years ago.

This paper addresses some of the IP issues that may arise when a party to litigation or a party to a license files for bankruptcy, and focuses primarily on sections of the Bankruptcy Code that impact the reorganization of the debtor. The Bankruptcy Code, and Chapter 11 in particular, is principally concerned with rehabilitating the debtor while minimizing losses by creditors. While not necessarily at odds with the concerns of IP law—protecting innovation or original expression and preventing consumer confusion—the Bankruptcy Code’s goals are sometimes in tension with those of IP law. The court’s application of the Bankruptcy Code can fundamentally alter or extinguish certain kinds of licensed IP rights as well as affect a party’s ability to enforce its IP rights against the debtor.

The Bankruptcy Code: General Principles

Most business bankruptcy proceedings are commenced voluntarily by the debtor filing a petition under Chapter 7 or Chapter 11 of the Bankruptcy Code. This creates a bankruptcy estate that generally consists of all of the debtor’s assets at the time the petition was filed. In Chapter 7 cases, the petition is filed to provide corporations with a mechanism “for an orderly liquidation of assets and distribution to creditors.”³ The bankruptcy court appoints a trustee to effectuate the

¹ The views expressed in this paper are the personal views of the authors and do not necessarily reflect those of Jones Day or its clients.

² See Statistics maintained by the American Bankruptcy Institute, Quarterly Business Filings By Year (1994-2009) at <http://www.abiworld.org/AM/AMTemplate.cfm?Section=Home&TEMPLATE=/CM/ContentDisplay.cfm&CONTENTID=58409>.

³ William L. Norton, Jr., 4 Norton Bankr. Law & Prac. § 74:2 (3d ed. 2009).

liquidation, and the trustee has sole control over the debtor's assets for the purpose of the liquidation.⁴

In contrast, Chapter 11 aims to facilitate the debtor's survival and ultimate emergence from bankruptcy. Chapter 11 permits a debtor to rehabilitate its business and discharge debts by reorganizing, conducting its affairs, and paying creditors in accordance with a court-approved plan.⁵ The debtor is usually allowed to continue operating and managing its business as a "debtor in possession" pursuant to sections 1107 and 1108 of the Bankruptcy Code. A debtor in possession in a Chapter 11 case has the same operational rights as a trustee.⁶ In cases where a debtor in possession is in derogation of its duty to manage its business, however, a trustee can be appointed by the court.⁷ This sometimes occurs at the request of the creditor's committee, which ordinarily consists of the unsecured creditors that hold the seven largest unsecured claims against the debtor.⁸ Important activities of the committee include consulting with the debtor in possession on administration of the case, investigating the debtor's conduct and operation of the business, and participating in formulating a plan of reorganization.⁹

While the ultimate goal of a Chapter 11 bankruptcy is to get the court to confirm a plan of reorganization, it is also possible for a debtor to liquidate assets under this chapter. In a Chapter 11 liquidation, the debtor in possession may oversee the liquidation, and can thus plan for the orderly divestiture of assets over time.¹⁰ In some cases this may benefit the creditor body more than a Chapter 7 liquidation that is managed by a trustee that is generally less familiar with the debtor's assets. Alternately, a Chapter 11 bankruptcy can be converted into a Chapter 7 bankruptcy.¹¹

From the standpoint of the IP practitioner, three sections of Chapter 11 tend to have the greatest impact on IP rights or the enforcement of such rights: section 362 (Automatic stay), section 363 (Use, sale, or lease of property), and section 365 (Executory contracts and unexpired leases).

⁴ See, e.g., *Monaco v. United States Dep't of Educ. (In re County Schs., Inc.)*, 163 B.R. 424, 430 (Bankr. D. Conn. 1994).

⁵ *In re Krohn*, 886 F.2d 123, 125-128 (6th Cir. 1989).

⁶ See, e.g., *Official Comms. of Unsecured Creditors v. Anderson Senior Living Prop. LLC (In re Nashville Senior Living, LLC)*, 407 B.R. 222, 227 n.6 (B.A.P. 6th Cir. 2009).

⁷ See, e.g., *Goldberg v. Craig (In re Hydro-Action, Inc.)*, 341 B.R. 186, 192 (Bankr. E.D. Tex. 2006).

⁸ 11 U.S.C. § 1102.

⁹ 11 U.S.C. § 1103.

¹⁰ See, e.g., *In re Deer Park, Inc.*, 136 B.R. 815, 818 (B.A.P. 9th Cir. 1992).

¹¹ See, e.g., *Myers v. Raynor (In re Raynor)*, 406 B.R. 375, 376 (B.A.P. 8th Cir. 2009).

Section 362: The Automatic Stay

Filing a bankruptcy petition causes an automatic stay of all court proceedings and other acts to collect *pre-petition* liabilities from the debtor. Pursuant to 11 U.S.C. section 362(a), the petition stays, *inter alia* and subject to certain exceptions:

- (1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;
- (2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;
- (3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;
- (4) any act to create, perfect, or enforce any lien against property of the estate;
- (5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;
- (6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;

Courts recognize the great breadth of the automatic stay and, with only a few specific exceptions, will prevent any attempts to enforce pre-petition claims or any actions that would affect property of the estate for the duration of the stay.¹²

The automatic stay's fundamental purpose is to give the debtor a breathing spell from its creditors and relieve the debtor of the financial pressures that drove it into bankruptcy.¹³ The automatic stay also safeguards creditors' rights by preventing "different creditors from bringing different proceedings in different courts, thereby setting in motion a free-for-all in which opposing interests maneuver to capture the lion's share of the debtor's assets."¹⁴ Additional benefits of the automatic stay are that it extends statutes of limitation to 30 days after termination

¹² See, e.g., *Carbaugh v. Carbaugh (In re Carbaugh)*, 278 B.R. 512, 524 (B.A.P. 10th Cir. 2002).

¹³ H.R.Rep. No. 95-595, 95th Cong., 1st Sess., at 340 (1977).

¹⁴ *Rijos v. Vizcaya (In re Rijos)*, 263 B.R. 382, 389 (B.A.P. 1st Cir. 2001).

of the stay and extends debtor deadlines to file claims or cure defaults until 60 days after petition.¹⁵ The duration of the stay is defined, subject to certain exceptions, by section 362(c):

(1) the stay of an act against property of the estate under subsection (a) of this section continues until such property is no longer property of the estate;

(2) the stay of any other act under subsection (a) of this section continues until the earliest of—

(A) the time the case is closed;

(B) the time the case is dismissed; or

(C) if the case is a case under chapter 7 of this title concerning an individual or a case under chapter 9, 11, 12, or 13 of this title, the time a discharge is granted or denied * * *¹⁶

In patent cases in which the debtor is one of multiple defendants, litigation may be stayed with respect to the debtor but allowed to proceed with respect to the other defendants. If, however, the claims against all of the defendants are “hopelessly intertwined,” the entire patent infringement action may be stayed.¹⁷

Pre-Petition vs. Post-Petition Claims

The automatic stay applies to any suit against the debtor that “could have been commenced before the filing of a bankruptcy petition or that asserts a cause of action that arose before the filing of a bankruptcy petition.”¹⁸ The automatic stay does not, however, generally apply to suits based on post-petition torts, including post-petition patent infringement. “Damages for wrongs done during the bankruptcy proceeding are administrative claims, and thus paid in full most of the time.”¹⁹

¹⁵ 11 U.S.C. § 108.

¹⁶ 11 U.S.C. § 362(c).

¹⁷ See, e.g., *Int’l Consumer Prods. of N.J., Inc. v. Complete Convenience, LLC*, No. 07-325 (MLC), 2008 WL 2185340, at *1 (D.N.J. May 23, 2008).

¹⁸ *Hazelquist v. Guchi Mochie Tackle Co., Inc.*, 437 F.3d 1178, 1180 (Fed. Cir. 2006).

¹⁹ *In re Mahurkar Double Lumen Hemodialysis Catheter Patent Litig.*, 140 B.R. 969, 977 (N.D. Ill. 1992) (Judge Easterbrook sitting by designation); see also *Lancaster Composite, Inc. v. Hardcore Composites Operations, LLC*, No. Civ. 04-1414-SLR, 2005 WL 121794, at *977 (D. Del. Jan. 14, 2005) (noting that default judgment had been entered against bankrupt debtor regarding post-petition acts of infringement; also noting that the Official Committee of Unsecured Creditors acknowledged that the automatic stay is not applicable to infringement claims arising post-petition).

For example, in *Alloc, Inc. v. Unilin Decor N.V.*, the court held that the automatic stay provision of the Bankruptcy Code was inapplicable where the asserted patent issued post-petition.²⁰ Other courts, such as the court in *Voice Sys. and Servs., Inc. v. VMX, Inc.*,²¹ have allowed patent suits based on post-petition conduct to proceed pursuant to 28 U.S.C. § 959(a), which states that:

Trustees, receivers or managers of any property, including debtors in possession, may be sued, without leave of the court appointing them, with respect to any of their acts or transactions in carrying on business connected with such property. Such actions shall be subject to the general equity power of such court so far as the same may be necessary to the ends of justice

Relying on section 959(a), the court in *Voice Sys. and Servs.* granted a preliminary injunction that prevented the debtor from continuing to sell the allegedly-infringing product. Interestingly, while filing a bankruptcy petition typically benefits the debtor in litigation by automatically staying pre-petition claims, here the court considered the debtor's bankruptcy to weigh in favor of granting preliminary injunctive relief. Because the debtor's Chapter 11 proceeding was an acknowledgement that its liabilities exceeded its assets, the court noted that the debtor would be unable to fully compensate the patent owner for damages caused by the debtor's past and present infringement.²² This left the patent owner with no adequate remedy at law, which the Court found to weigh in favor of granting a preliminary injunction.²³

On the other hand, bankruptcy courts retain significant discretion to implement stays of litigation and will occasionally bar suits even when based on post-petition conduct. The above reference to the court's "equity power" in section 959(a) has sometimes been used to anchor decisions to preclude suits based on post-litigation conduct, as explained by the court in *In re Television Studio Sch. of N. Y.*:

The policy behind the second sentence is to limit the seemingly unfettered power to bring suit against a debtor-in-possession, where to do so would significantly interfere with the orderly administration of the debtor's estate. Thus, while it is essential to allow most of these suits [based on post-petition conduct] to proceed without leave, there will inevitably be instances when to allow a suit of this type would substantially impede the reorganization of the debtor.²⁴

²⁰ *Alloc, Inc. v. Unilin Decor N.V.*, No. 02-C-1266, 2005 WL 3448060, at *1 (E.D. Wis. Dec. 15, 2005).

²¹ *Voice Sys. and Servs., Inc. v. VMX, Inc.*, 26 U.S.P.Q.2d 1106, 1113 (N.D. Okla. 1992).

²² *Id.* at 1112.

²³ *Id.*

²⁴ *In re Television Studio Sch. of N.Y.*, 77 B.R. 411, 412 (Bankr. S.D.N.Y. 1987).

Similarly, in *In re Telegroup, Inc.*, the plaintiff sought permission to file suit in another forum for post-petition damages arising during a three month window of time in which the debtor was alleged to have engaged in patent infringement.²⁵ Although precedent suggested that such claims fell within section 959(a), the court exercised its discretion to deny plaintiff's request under its general equity powers.²⁶ In so holding, the court reasoned that it, rather than a different tribunal, should determine the validity of the plaintiff's proof of administrative claim in the event that the debtor filed an objection to that claim.²⁷

The Police or Regulatory Power Exception to the Automatic Stay is Unlikely to Apply to ITC Investigations

Under 11 U.S.C. § 362(b)(4), the automatic stay does not apply to governmental assertions of police or regulatory powers such as suits by government entities to “prevent or stop violation of fraud, environmental protection, consumer protection, safety, or similar police or regulatory laws, or attempting to fix damages for violation of such a law....”²⁸ Litigants attempting to use this exception to argue that the automatic stay does not apply in section 337 United States International Trade Commission investigations have met with increasing resistance.

The ITC, in a Commission Opinion, has held that section 337 investigations fall within the section 362(b)(4) exception from the automatic stay.²⁹ In *In the Matter of Certain Semiconductor Chips with Minimized Chip Package Size and Products Containing Same*, the Commission explained:

Preventing violation of domestic industries' intellectual property rights falls squarely within the “regulatory power” of a “governmental unit.” Therefore, Section 337 falls within the exception of section 362(b)(4). The Commission, thus, denies Spansion's request to stay the investigation.³⁰

Because the Commission found that section 337 investigations fall within the section 362(b)(4) exception, it denied the bankruptcy debtor's request to apply the automatic stay provision.

Bankruptcy courts, however, have reached the opposite conclusion in a series of increasingly detailed opinions. In *In re Qimonda AG*, Qimonda and several other respondents

²⁵ *In re Telegroup, Inc.*, 237 B.R. 87, 95 (Bankr. D.N.J. 1999)

²⁶ *Id.*

²⁷ *Id.*

²⁸ Reform Act of 1978, H. Rep. No. 595, 95th Cong., 1st Sess., at 343 (1977); S. Rep. No. 989, 95th Cong., 2d Sess., at 52 (1978).

²⁹ *In the Matter of Certain Semiconductor Chips with Minimized Chip Package Size and Products Containing Same*, Inv. No. 337-TA-605, 2009 ITC LEXIS 841 (ITC June 3, 2009).

³⁰ *Id.* at *109-110.

were accused of infringement in an ITC action.³¹ Because Qimonda was involved in a foreign insolvency proceeding for which it sought recognition in the United States Bankruptcy Court for the Eastern District of Virginia—which, if granted, would invoke the automatic stay of section 362—it sought an injunction staying the ITC action pending a decision on recognition by the bankruptcy court. After analyzing the factors for a preliminary injunction (likelihood of success, irreparable harm, balance of equities, public interest), the court held that the ITC action should be stayed with respect to Qimonda pending the court’s decision on recognition, but that Qimonda would be bound by the ITC’s decision on validity at the trial with the remaining respondents to the same extent as if Qimonda had participated in the trial.³² In so holding, the court noted that litigation initiated by a private party under section 337 of the Tariff Act of 1930 before the ITC does not meet the requirements of the section 362(b)(4) police power exception—rendering such actions subject to the automatic stay:

The ITC serves several functions. In the LSI patent litigation before the ITC, it is acting in its judicial capacity, not its enforcement capacity. It is adjudicating a case involving an alleged infringement of a patent by certain imports. The case was commenced by individual private parties against individual private parties. The private parties are the real parties in interest...It is the forum for the litigation; the tribunal before which the case is tried. It is not the instigator or the prosecutor. The exception to § 362(a) for governmental units under § 362(b)(4)...is not applicable in this case.³³

Although the complainant asked the ITC to disregard the bankruptcy court’s stay order and go forward with the proceeding against Qimonda, the administrative law judge instead gave effect to the bankruptcy court’s ruling and stayed the ITC action.³⁴

In October 2009, the United States Bankruptcy Court for the District of Delaware followed *Qimonda* and held that “police and regulatory” exception does not apply to ITC proceedings.³⁵ In *In re Spansion*, Samsung argued that its ITC action against Spansion should be allowed to proceed under that exception.³⁶ The court applied a hybrid two-part test that focused on whether the ITC proceeding adjudicated private rights or effectuated public policy.³⁷ The

³¹ *In re Qimonda AG*, No. 09-14766-RGM, 2009 WL 2210771, at *2-3 (Bankr. E.D. Va., July 16, 2009).

³² *Id.*

³³ *Id.* at *5-6.

³⁴ *In re Certain Semiconductor Integrated Circuits Using Tungsten Metallization and Products Containing the Same*, Order No. 110, No. 337-TA-648, 2009 WL 2122070 (U.S.I.T.C. July 15, 2009).

³⁵ *In re Spansion, Inc.*, No. 09-10690 (KJC), 09-11480 (KJC), 2009 WL 3170304 (Bankr. D. Del., Oct. 1, 2009).

³⁶ *Id.* at *6.

³⁷ *Id.* at *7.

court ultimately held, consistent with *Qimonda*, that the primary thrust of Samsung’s ITC action was to adjudicate patent infringement claims of private parties for the benefit of Samsung.³⁸ Therefore, because the Samsung ITC action only incidentally served the goal of preventing unfair competition, the automatic stay applied to that action.³⁹

Most recently, the *In re Qimonda AG* court issued a detailed memorandum opinion wherein it refused to apply the section 362(b)(4) exception to the automatic stay to an ITC action.⁴⁰ After the court granted provisional relief to Qimonda, as discussed above, LSI and the ITC renewed their argument at the recognition hearing that the police and regulatory power exception applied to the ITC action.⁴¹ The court rejected this argument because it held that (1) the action pending before the ITC was not a continuation of an action by the ITC and (2) the action was not an enforcement of the ITC’s police and regulatory power, as required by section 362(b)(4).⁴²

The court noted that while staff attorneys from the Office of Unfair Import Investigations do participate in ITC actions, these attorneys do not control or direct either the complainant or the respondent.⁴³ The court ultimately held that the ITC is the forum before which private litigants enforce their patents, not a governmental unit that itself enforces those patents.⁴⁴ As the action was *before* the ITC, but not *by* the ITC, the exception of section 362(b)(4) was inapplicable.⁴⁵

The *In re Qimonda AG* court further held that even if ITC action had been *by* the ITC, it was not an enforcement of the ITC’s police and regulatory powers. The court applied the “pecuniary interest test,” which says that an action is not an action to enforce a police or regulatory power if the governmental unit’s primary purpose is to further its pecuniary interest.⁴⁶ The court found that when a governmental unit seeks to exercise creditor remedies, it does not protect the public’s health and safety, but rather disrupts the bankruptcy proceeding to the detriment of other creditors.⁴⁷

³⁸ *Id.* at *8.

³⁹ *Id.* Samsung has appealed this decision to the District Court, which in turn has referred the case to an Appellate Mediation Panel.

⁴⁰ *In re Qimonda AG*, No. 09-14766-RGM (Chapter 15)(Bankr. E.D. Va., February 16, 2010).

⁴¹ *Id.* at 1-2.

⁴² *Id.* at 3.

⁴³ *Id.* at 5.

⁴⁴ *Id.* at 6.

⁴⁵ *Id.*

⁴⁶ *Id.* at 8.

⁴⁷ *Id.* at 8-9.

The court also applied the “private rights test,” which says that an action is not an action to enforce police and regulatory power if the governmental unit seeks primarily to further private rights.⁴⁸ The ITC argued that the public policy underlying the Tariff Act of 1930 is the protection of domestic industries from patent infringement.⁴⁹ The court disagreed, and found that the applicable provisions of the Tariff Act of 1930 exist primarily to protect patent holders, noting that the outcome of an ITC action does not affect domestically produced goods.⁵⁰ As the ITC action was primarily for the benefit of private parties, the section 362(b)(4) exception did not apply.⁵¹ The court concluded by noting its holding was consistent with the holding in *Spanston*.⁵²

The Automatic Stay and Suits By the Debtor

An important characteristic of the automatic stay is that while it generally prevents litigation activities *against* the debtor, it is far less restrictive of litigation activities *by* the debtor. 11 U.S.C. section 362(a)(1) states that the stay applies to actions “against the debtor,” and 11 U.S.C. section 362(a)(3) states that the stay applies to acts to obtain possession of or to exercise control over property of the estate.⁵³ Section 362 does not, however, prevent the trustee or debtor in possession from prosecuting or appearing in an action that the debtor initiated and that is pending at the time of bankruptcy.⁵⁴

A party sued by the debtor retains the ability to defend itself: “There is ... no policy of preventing persons whom the bankrupt has sued from protecting their legal rights. True, the bankrupt’s cause of action is an asset of the estate; but as the defendant in the bankrupt’s suit is not, by opposing that suit, seeking to take possession of it, subsection (a)(3) is no more applicable than (a)(1) is.”⁵⁵ “Out of fairness, the defendant should be allowed to defend himself from attack, and the automatic stay should not tie the hands of a defendant while the plaintiff debtor is given free rein to litigate.”⁵⁶ Courts have held that creditors can move to dismiss a

⁴⁸ *Id.* at 9.

⁴⁹ *Id.*

⁵⁰ *Id.* at 10.

⁵¹ *Id.*

⁵² *Id.*

⁵³ See also, e.g., *Martin-Trigona v. Champion Fed. Sav. & Loan Ass’n*, 892 F.2d 575, 577 (7th Cir. 1989).

⁵⁴ See, e.g., *In re White*, 186 B.R. 700, 704 (B.A.P. 9th Cir. 1995). Note, however, that the automatic stay may restrict certain litigation activities of the debtor to the extent that they relate to claims that are otherwise subject to the automatic stay. For example, courts have held that the debtor will be stayed by section 362 from appealing an unfavorable judgment in an action that was originally brought against the debtor. *Id.* at 704-05.

⁵⁵ *Martin-Trigona*, 892 F.2d at 577.

⁵⁶ *Ingersoll-Rand Fin. Corp. v. Miller Mining Co., Inc.*, 817 F.2d 1424, 1426-27 (9th Cir. 1987); see also *Cathey v. Johns-Manville Sales Corp.*, 711 F.2d 60, 62 (6th Cir. 1983), *cert. denied*, 106 S.Ct. 3335 (1986).

debtor's lawsuit so long as that creditor asserts no counterclaims.⁵⁷ A defendant's ability to assert counterclaims against the debtor, however, is a more complicated issue.

The Automatic Stay and Counterclaims

Counterclaims against the debtor are generally barred. In *Koolik v. Markowitz*, the court held that: “[S]ince a defendant who is awarded judgment on a counterclaim is no less a judgment creditor than is a plaintiff who is awarded judgment on a claim asserted in the complaint, we construe the term ‘action or proceeding’... to include any pleading that asserts a claim on which relief is sought.”⁵⁸ In this way, the Second Circuit held that an answer that asserts a counterclaim against a plaintiff that becomes a bankruptcy debtor is an “action or proceeding against the debtor” within the meaning of 11 U.S.C. section 362(a)(1), regardless of whether the plaintiff initiated the lawsuit.⁵⁹

In fact, courts have held that counterclaims against a debtor may be suspended even though closely related claims asserted by the debtor may continue.⁶⁰ For example, in *Maritime Elec. Co. v. United Jersey Bank*, the Third Circuit noted that multiple claim and multiple party litigation must be disaggregated so that “particular claims, counterclaims, crossclaims and third-party claims are treated independently when determining which of their respective proceedings are subject to the bankruptcy stay.”⁶¹ As a result of this disaggregation, actions against a debtor will be stayed even though closely related claims or counterclaims asserted by the debtor may continue in the same case.⁶² The court further clarified that the automatic stay is not available to non-bankrupt co-defendants of a debtor even if they are in a similar legal or factual nexus with the debtor.⁶³ While this approach is not adopted in every case, it creates the potential for an unbalanced scenario wherein the debtor can vigorously pursue its claims while the adverse party is frozen in a stay with respect to its counterclaims.

The Federal Circuit has been hard to predict with respect to this issue. Citing judicial economy, the Federal Circuit in *Robert Tyer & Assocs., Inc. v. Envtl. Dynamics, Inc.*, expressed discomfort with staying one side while allowing the other to proceed with respect to closely related issues.⁶⁴ The court noted that while the matter before it was not entirely clear, “it appear[ed] that the issues underlying the claims of tortious interference and antitrust violations [were] substantially similar to those involved in [the counterclaimant’s] counterclaim for patent

⁵⁷ *In re Sheppard*, No. 06-65467, 2006 Bankr. LEXIS 1368, at *3 (Bankr. N.D. Ga. July 12, 2006).

⁵⁸ *Koolik v. Markowitz*, 40 F.3d 567, 568 (2d Cir. 1994).

⁵⁹ *Id.*

⁶⁰ *See, e.g., Maritime Elec. Co. v. United Jersey Bank*, 959 F.2d 1194, 1205 (3d Cir. 1991).

⁶¹ *Id.* at 1204-05 (internal citations omitted).

⁶² *Id.*

⁶³ *Id.*

⁶⁴ *Robert Tyer & Assocs., Inc. v. Envtl. Dynamics, Inc.*, No. 95-1270, 1995 WL 470526, at * 2 (Fed. Cir. July 14, 1995).

infringement.”⁶⁵ Another issue significant to the court was that granting appellate review of the debtor’s claims would require it to consider issues that were the subject of a stay mandated by statute.⁶⁶ For these reasons, the court stayed all claims at issue in the debtor’s appeal.⁶⁷

In other cases, however, the Federal Circuit has expressly followed the *Maritime* approach. In *Halmar Robicon Group, Inc. v. Toshiba Int’l Corp.* the Federal Circuit held that the automatic stay did not apply to the debtor’s infringement claims, but did apply to the declaratory judgment claims filed by the accused infringer against the patentee. In that case, a final judgment of noninfringement was entered on the claim brought by the debtor against the alleged infringer.⁶⁸ The debtor waited almost seven months before appealing this judgment. The Federal Circuit noted that *only* the alleged infringer’s declaratory judgment claims were subject to the automatic stay.⁶⁹ The Federal Circuit found no law to toll the time to file the notice of appeal from final judgment for that part of the case brought by the debtor.⁷⁰ For this reason the court held that “[the debtor]’s appeal of the judgment of noninfringement, filed nearly seven months after the entry of final judgment and the filing of the bankruptcy petition, [was] untimely and must be dismissed.”⁷¹

Modification of the Automatic Stay to Allow Suit Against the Debtor

Pursuant to 11 U.S.C. section 362(d)(1), a potential plaintiff may be able to obtain relief from the automatic stay to bring a suit against a debtor, even in circumstances where the automatic stay applies, if the plaintiff can demonstrate “cause.” Such a modification of the automatic stay “for cause” may permit an action to proceed against the debtor in another tribunal.⁷² What constitutes “cause” for granting relief from the automatic stay is decided on a case-by-case basis.⁷³ As the term “cause” is not defined in the Bankruptcy Code, the decision of what constitutes proper “cause” for allowing litigation before another tribunal is necessarily an exercise of the court’s discretion.⁷⁴ Courts have adopted a nonexclusive list of twelve factors, known as the *Curtis* test, to assist with making this highly discretionary, fact-intensive

⁶⁵ *Id.*

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ *Halmar Robicon Group, Inc. v. Toshiba Int’l Corp.*, 127 Fed. Appx. 501, 503 (Fed. Cir. 2005).

⁶⁹ *Id.* at 502-3.

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² *In re Curtis*, 40 B.R. 795, 799 (Bankr. D. Utah 1984).

⁷³ *See, e.g., In re Tucson Estates, Inc.*, 912 F.2d 1162, 1166 (9th Cir. 1990); *In re MacDonald*, 755 F.2d 715, 717 (9th Cir. 1985).

⁷⁴ *See, e.g., In re Olmstead*, 608 F.2d 1365, 1367 (10th Cir. 1979).

determination.⁷⁵ Courts have relied on these *Curtis* factors when determining whether or not to lift the stay in litigation related to IP rights.⁷⁶

Even If Suit Against the Debtor is Allowed, The Automatic Stay May Bar Execution of Judgment

Even if a patent infringement lawsuit against the debtor is allowed to go forward, the automatic stay may place limitations on the patentee's ability to collect on a judgment for money damages. For example, in *Larami Ltd. v. Yes! Entertainment Corp.* the court held that while an infringement suit based on post-petition activities was not stayed under section 362(a)(3), "the execution or attachment of a judgment obtained as a result of a post-petition claim would be barred."⁷⁷

Bankruptcy and Litigation Settlements

An important aspect of litigation in the shadow of bankruptcy is that any settlement agreements are subject to the approval of the bankruptcy judge, who will determine if such settlement is fair to the bankrupt's estate and creditors. Pursuant to the Federal Rules of Bankruptcy Procedure, approval of a settlement is a matter for the court's discretion:

On motion by the trustee and after notice and a hearing, the court may approve a compromise or settlement. Notice shall be given to creditors, the United States trustee, the debtor, and indenture trustees as provided in Rule 2002 and to any other entity as the court may direct.⁷⁸

The court must decide whether "the compromise is fair, reasonable, and in the best interest of the estate."⁷⁹ "Under the 'fair and equitable' standard, [the court looks] to the fairness

⁷⁵ *In re Curtis*, 40 B.R. 795, 799-802 (Bankr. D. Utah 1984); *see also, e.g., Kronemyer v. Am. Contractors Indem. Co. (In re Kronemyer)*, 405 B.R. 915, 921 (B.A.P. 9th Cir. 2009) (endorsing the *Curtis* factors as "appropriate, nonexclusive, factors" to consider in determining whether to allow pending litigation to proceed against the debtor in another forum.).

⁷⁶ *See, e.g., In re Deep*, 279 B.R. 653, 657-660 (Bankr. N.D.N.Y. 2002)(analyzing the equivalent of the twelve *Curtis* factors to find that "cause" existed to lift stay to allow copyright holders to pursue their request for preliminary injunction); *Truebro, Inc. v. Plumberex Specialty Products, Inc. (In re Plumberex Specialty Products, Inc.)*, 311 B.R. 551, 559 (Bankr. C.D. Cal. 2004)(analyzing the *Curtis* factors to find that no "cause" existed to lift stay to allow a contempt action for violation of an injunction where such contempt action would be new and separate from the previous litigation).

⁷⁷ *Larami Ltd. v. Yes! Entm't Corp.*, 244 B.R. 56, 58 (D.N.J. 2000).

⁷⁸ FED. R. BANKR. P. 9019(a); *see also Key3Media Group, Inc. v. Pulver.com, Inc. (In re Key3Media Group, Inc.)*, 336 B.R. 87, 92 (Bankr. D. Del. 2005); 11 U.S.C. § 105 (setting forth broad discretionary powers of court).

⁷⁹ *In re TSIC, Inc.*, 393 B.R. 71, 78 (Bankr. D. Del. 2008) (quoting *In re Louise's, Inc.*, 211 B.R. 798, 801 (D. Del. 1997)).

of the settlement to the other persons, i.e., the parties who did not settle.”⁸⁰ “In the final analysis, the court does not have to be convinced that the settlement is the best possible compromise. Rather, the court must conclude that the settlement is within the reasonable range of litigation possibilities.”⁸¹ The debtors carry the burden of persuading the court that the compromise falls within the reasonable range of litigation possibilities.⁸² Therefore, litigants must be aware of the very real possibility that their mutually-agreed-to settlement terms might be rejected.

When considering the best interest of the estate, the Court must “assess and balance the value of the claim that is being compromised against the value to the estate of the acceptance of the compromise proposal.”⁸³ In striking this balance, courts typically should consider the factors from *In re Martin*: (1) the probability of success in litigation; (2) the likely difficulties in collection; (3) the complexity of the litigation involved, and the expense, inconvenience, and delay necessarily attending it; and (4) the paramount interest of creditors.⁸⁴

A vivid example of the court’s power to reject settlement agreements arose recently in *In re Spansion, Inc.*⁸⁵ The debtor Spansion sued Samsung Electronics Co., Ltd. for patent infringement in multiple venues: International Trade Commission Investigation No. 337-TA-664 and Civil Action No. 08-855-SLR in the United States District Court for the District of Delaware. Samsung, in turn, filed infringement counterclaims in the Delaware action against Spansion and initiated suit in Japan against Spansion’s Japanese subsidiary (Tokyo District Court, actions entitled H21 (WA) 1989 and H21 (WA) 1986). The parties agreed to dismiss all litigation in a settlement agreement that included a \$70 million payment from Samsung. Although the Official Committee of Unsecured Creditors (“the Committee”) filed a limited objection to the settlement agreement, this objection was withdrawn at the hearing. An *ad hoc* consortium of holders of certain senior secured notes also objected to the settlement agreement, and maintained its objection through the hearing.

Notwithstanding the Committee’s agreement, the court rejected the settlement, holding that “the Debtors have failed to meet their burden of proving that the Settlement Agreement is fair and equitable, and in the best interest of the estate.”⁸⁶ With respect to the first *Martin* factor, the court noted that the debtor made its decision to settle without the advice of its patent litigation counsel.⁸⁷ The court was quite critical of this failure to involve patent litigation

⁸⁰ *Will v. Nw. Univ. (In re Nutraquest, Inc.)*, 434 F.3d 639, 645 (3d Cir. 2006).

⁸¹ *In re World Health Alternatives, Inc.*, 344 B.R. 291, 296 (Bankr. D. Del. 2006) (internal quotations and citations omitted).

⁸² *In re Key3Media Group, Inc.*, 336 B.R. at 93.

⁸³ *Myers v. Martin (In re Martin)*, 91 F.3d 389,393 (3d Cir. 1996) (citing *Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson*, 390 U.S. 414, 424-25 (1968)).

⁸⁴ *In re Martin*, 91 F.3d at 393.

⁸⁵ *In re Spansion, Inc.*, No. 09-10690(KJC), 2009 WL 1531788, at *1 (Bankr. D. Del. June 2, 2009).

⁸⁶ *Id.* at 8.

⁸⁷ *Id.* at 14.

counsel in the settlement process: “Under these circumstances, it seems unlikely that a reasonable evaluation of the merits of litigation of this nature and extent could have been made without taking into account the advice of patent litigation counsel.”⁸⁸ The second *Martin* factor was less problematic, as there was no evidence that there would be collection difficulties with respect to Samsung.⁸⁹ The court then expressly linked the third *Martin* factor to the first: “There is insufficient information upon which to make a reasoned decision as to the likelihood of success of the Actions. This likewise makes it difficult to conclude that the settlement is preferable to the expense, inconvenience and delay of litigation.”⁹⁰ The court also linked the fourth *Martin* factor to the first, noting that even though the Committee had withdrawn its objections at the hearing, “because this record does not allow a proper evaluation of the strengths and weaknesses of the Actions or the appropriateness of the proposed settlement payment, I cannot weigh heavily the Committee’s position.”⁹¹

In view of *In re Spansion*, patent litigation counsel’s involvement in the settlement process may be important to settlement approval.

Disaggregation of IP Rights in Bankruptcy and Litigation

A complication can arise with respect to litigation in the shadow of bankruptcy if the bankruptcy plan disaggregates certain IP rights in such a way that constitutional standing to sue is lost. For example, in *Morrow v. Microsoft Corp.*, three trusts were created to liquidate the debtor’s assets pursuant to a Chapter 11 liquidation plan.⁹² The liquidation plan distributed certain assets and rights among the trusts. One trust, BHLT, was given rights to claims for misappropriation or infringement of the debtor’s IP rights by its controlling shareholders.⁹³ A different trust, AHLT, was given ownership rights in the debtor’s IP.⁹⁴ A third trust, GUCLT, was granted the right to sue infringers that were not controlling shareholders.⁹⁵ Thus, while AHLT received legal title to certain patents under the liquidation, it did not have the right to sue third parties for infringement of the patent.⁹⁶

Disaggregating the IP rights in this manner would prove fatal to GUCLT’s ability to pursue patent infringement claims against Microsoft. The fundamental problem for GUCLT and AHLT was that the liquidation plan contractually separated the right to sue for infringement from

⁸⁸ *Id.*

⁸⁹ *Id.*

⁹⁰ *Id.* at 15.

⁹¹ *Id.* at 16.

⁹² *Morrow v. Microsoft Corp.*, 499 F.3d 1332, 1335 (Fed. Cir. 2007).

⁹³ *Id.*

⁹⁴ *Id.*

⁹⁵ *Id.* at 1342.

⁹⁶ *Id.* at 1335.

the underlying legally protected interest created by the patent statutes—the right to exclude.⁹⁷ The court reasoned that any suit initiated by GUCLT would be for violations of AHLT’s exclusionary interest, and GUCLT would not be the party granted judicial relief under the statute for such a grievance.⁹⁸

Moreover, the court held that AHLT’s addition as a party to the case could not cure the standing problem.⁹⁹ While the court recognized that a party with the rights of an exclusive licensee has standing to sue for infringement if the patentee joins the suit to satisfy any prudential concerns present in that case, it rejected the application of this analysis to GUCLT. Because GUCLT lacked the exclusionary interest of an exclusive licensee, it did not suffer the requisite legal injury to be a party to the infringement suit.

[] AHLT’s participation as a third party defendant does not affect GUCLT’s standing to bring this suit. To demonstrate entitlement to join as a *co-plaintiff* GUCLT must have the right to exclude others from making, using, or selling the invention in the United States. * * * [] GUCLT lacks legal injury in fact, and its beneficial interest in assets held by AHLT or the fact that AHLT has been brought into this case as a third party defendant does not cure GUCLT’s constitutional standing deficiencies.¹⁰⁰

Thus, *Morrow v. Microsoft Corp.* demonstrates that redistributing IP rights among post-bankruptcy entities without regard to maintaining constitutional standing can leave the entities without the ability to enforce those rights.

Bankruptcy of a Licensor

When a company enters bankruptcy, one of the key decisions it will face is whether to assume, reject, or assume and assign to a third party its executory contracts. For a debtor that is an IP owner-licensor, such “executory contracts” generally include any IP licenses to which it is a party. A debtor-licensor may also choose to sell its IP to a third party, and under certain circumstances, this sale may extinguish any third-party interests in the IP—including existing licenses. Although these debtor’s rights do advance the Bankruptcy Code’s primary goal—rehabilitating the debtor and protecting the creditor body—they can work a significant hardship on the debtor’s pre-petition licensees.

Fortunately, the Bankruptcy Code allows licensees to elect to retain the right to use certain kinds of licensed IP even when the licensor rejects the underlying license. Moreover, in certain circumstances, a licensee can retain substantial rights in IP that is sold by the debtor-

⁹⁷ *Id.* at 1342.

⁹⁸ *Id.*

⁹⁹ *Id.* at 1343.

¹⁰⁰ *Id.* at 1343.

licensor. As further discussed below, the licensing parties' respective rights will vary greatly depending on the kind of IP involved, the terms of the license, and the action or inaction of the licensee.

Section 365: Assumption or Rejection of Executory Contracts

One of the greatest benefits of bankruptcy to a debtor is the ability to assume or reject executory contracts. Section 365(a) provides that “the trustee, subject to the court’s approval, may assume or reject any executory contract or unexpired lease of the debtor.”¹⁰¹ Pursuant to 11 U.S.C. section 1107(a) the debtor-in-possession may act as trustee.

A debtor choosing to “assume” a contract is simply agreeing to be bound by its terms going forward. In order to assume a contract, the debtor must meet certain requirements specified in section 365(b)(1), including curing or providing adequate assurance that the trustee will cure any defaults and providing adequate assurance of future performance. Once a contract is assumed, the debtor will be bound by its terms, and any future breach likely will result in a post-petition claim for damages entitled to priority as an administrative claim (typically at 100 cents on the dollar).

On the other hand, a debtor choosing to “reject” a contract is refusing to be bound by its terms going forward. A rejection is treated as a court-authorized breach of the contract *as of the petition date* pursuant to 11 U.S.C. section 365(g). The fact that a rejection constitutes a pre-petition breach has major ramifications, as “[t]he non-debtor party to the contract subject to rejection is limited in its claims for breach to the treatment accorded to a debtor’s general unsecured creditors.”¹⁰² This means that the non-debtor party’s claim for breach will be accorded the same priority as claims by the general unsecured creditor body, and likely discharged for cents on the dollar.

As a general matter, a debtor has wide latitude to assume or reject executory contracts, provided that the debtor satisfies the liberal “business judgment” standard.¹⁰³ While the court may place equitable restrictions on the debtor’s ability to reject contracts in an extreme case, “[g]enerally, absent a showing of bad faith, or an abuse of business discretion, the debtor’s business judgment will not be altered.”¹⁰⁴

IP Licenses are Usually Executory Contracts

Whether a contract is executory and thus subject to assumption or rejection in bankruptcy is a question of federal law.¹⁰⁵ While the Bankruptcy Code does not specifically define the term

¹⁰¹ 11 U.S.C. § 365(a) (2000).

¹⁰² *In re Walnut Assocs.*, 145 B.R. 489, 494 (Bankr. E.D. Pa. 1992).

¹⁰³ *See, e.g., COR Route 5 Co., LLC v. Penn Traffic Co. (In re Penn Traffic Co.)*, 524 F.3d 373, 383 (2d Cir. 2008).

¹⁰⁴ *In re G Survivor Corp.*, 171 B.R. 755, 757 (Bankr. S.D.N.Y. 1994).

¹⁰⁵ *In re Wegner*, 839 F.2d 533, 536 (9th Cir. 1988).

“executory contract,” the Supreme Court has defined it as a contract “on which performance remains due to some extent on both sides.”¹⁰⁶ Circuit law has further defined a contract as executory if *material* unperformed obligations remain for both parties.¹⁰⁷

Courts have held that common terms in most IP licenses generally render them executory. For example, duties of confidentiality, duties to give notice of lawsuits, and duties to defend IP against third-party validity challenges may render a license executory. In *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, the court found that a non-exclusive license agreement to use patented technology was executory based on “[t]he unperformed, continuing core obligations of notice and forbearance in licensing.”¹⁰⁸ Similarly, the court in *In re Kmart Corp* noted that “[g]enerally speaking, a license agreement is an executory contract as such is contemplated in the Bankruptcy Code.”¹⁰⁹ In fact, even “fully paid up” licenses are generally executory, as was the case in *In re Aerobox Composite Structures*: “While the Court recognizes that the monetary consideration required under the License Agreement has been paid in full, the Court finds that the License Agreement is executory due to the continuing material duties and obligations of both parties to the License Agreement. . . .”¹¹⁰

Assumption and Assignment of Contracts

In addition to assumption or rejection of an executory contract, the Bankruptcy Code provides a third option for debtors: assumption and assignment. If the debtor can provide adequate assurance that the assignee can perform, the debtor may generally assume and assign an executory contract even if the contract prohibits assignment by its own terms.¹¹¹ Section 365(c) of the Bankruptcy Code does, however, restrict a debtor’s ability to “assume or assign” certain kinds of contracts:

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

(1)(A) *applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession*, whether or not such contract or lease

¹⁰⁶ *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 522 n. 6 (1984).

¹⁰⁷ *See, e.g., In re Qintex Entm’t, Inc.*, 950 F.2d 1492, 1495 (9th Cir. 1991).

¹⁰⁸ *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043, 1045 (4th Cir. 1985).

¹⁰⁹ *In re Kmart Corp.*, 290 B.R. 614, 618 (Bankr. N.D. Ill. 2003) (quoting *Novon Int’l v. Novamont S.P.A. (In re Novon Int’l)*, 96-BK-15463B, 2000 WL 432848, at *4 (W.D.N.Y. March 31, 2000)).

¹¹⁰ *In re Aerobox Composite Structures, LLC*, 373 B.R. 135, 139 (Bankr. D.N.M. 2007).

¹¹¹ 11 U.S.C. § 365(f).

prohibits or restricts assignment of rights or delegation of duties;
and

(1)(B) such party does not consent to such assumption or
assignment;....¹¹²

Thus, while a debtor may generally assign an executory contract to a third party notwithstanding limitations on assignment in the contract itself, certain kinds of contracts, such as contracts for personal services, may not be assigned to a third party absent consent by the non-debtor party.

Although the conditions specified in section 365(c)(1)(A) are centered around a party's ability to assign a contract, the language of section 365(c) has generated significant confusion insofar as it appears to require that the contract meet the same conditions even in the case of a straight assumption. In other words, section 365(c) states that the trustee cannot assume *or* assign any executory contract for which an applicable law would prevent its *assignment*. Read literally, this would appear to prevent a debtor from even assuming a contract that it could not otherwise assign under common law. As will be discussed in greater depth below with respect to the bankruptcy of a licensee, this language has created considerable complexity with respect to IP licenses, and circuits have split on the proper interpretation of this section.

Sections 365(n) and 101(35A) - Effect of Rejection on “Intellectual Property” Licenses

A debtor-licensor's ability to reject licenses under section 365(a) creates a tremendous danger that licensees may have their licenses rejected in bankruptcy—a disastrous outcome for licensees in many cases. The Fourth Circuit came to exactly such a result in *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, holding that (1) the debtor licensor could reject a non-exclusive technology license and (2) the former licensee had no ability to seek specific performance with respect to the rejected license.¹¹³ Congress responded to the harshness of the *Lubrizol* holding by enacting the Intellectual Property Licenses in Bankruptcy Act (“IPLBA”) in October 1988 to protect licensees' rights to certain types of intellectual property in the event of a bankruptcy. The key IPLBA provisions are now codified as sections 365(n) and 101(35A) of the Bankruptcy Code.

Pursuant to section 365(n), if a trustee rejects an executory “intellectual property” license under section 365(a), the licensee may elect either:

(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 nonbankruptcy law, or an agreement made by the licensee with another entity; or

¹¹² 11 U.S.C. § 365(c) (emphasis added).

¹¹³ *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043, 1046-48 (4th Cir. 1985), *cert. denied*, 475 U.S. 1057, 106 S. Ct. 1285, 89 L. Ed. 2d 592 (1986).

(B) to retain its rights (including a right to enforce any exclusivity provision of such contract, but excluding any other right under applicable nonbankruptcy 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 nonbankruptcy 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 nonbankruptcy law.

This means that an “intellectual property” licensee has a powerful and important option not available to other kinds of contracting parties: To retain certain rights in the face of the debtor’s rejection.

For purposes of section 365(n), “intellectual property” has a specific definition that excludes certain important classes of IP. Section 101 (35A) defines “intellectual property” to mean a:

(A) trade secret;

(B) invention, process, design, or plant protected under title 35;

(C) patent application;

(D) plant variety;

(E) work of authorship protected under title 17; or

(F) mask work protected under chapter 9 of title 17.

to the extent protected by applicable nonbankruptcy law. Thus, trademarks, service marks, trade names, and rights of publicity are all excluded from the section 365(n) election provision.¹¹⁴ Furthermore, foreign patents and copyrights are not included within the scope of section 365(n), as they are not covered by title 35 or 17 of the United States Code.

If the licensee elects to retain its rights under the license, it must make all royalty payments due under the contract and will be deemed to have waived any administrative claim

¹¹⁴ See also, e.g., *In re Old Carco LLC*, 406 B.R. 180, 211 (Bankr. S.D.N.Y. 2009).

arising from the performance of the contract.¹¹⁵ While the Bankruptcy Code does not define “royalty payments,” the legislative history suggests a broad interpretation of the concept:

It is important that courts, in construing the term “royalty” used in this subsection, and in deciding what payments are royalty payments, look to the substance of the transaction and not the label. The underlying nature of the payments must be considered. For example, payments based upon the use of intellectual property or on a percentage of sales of end products that incorporate or are derived from the intellectual property should be treated as royalty payments.¹¹⁶

Based on the legislative history, the *Prize Frize* court held that even flat license fees should be viewed as “royalties” for the purpose of section 365(n).¹¹⁷

By opting to retain its license pursuant to section 365(n), the licensee generally does not retain any ability to enforce affirmative obligations for things such as maintenance, support, and development obligations.¹¹⁸ The licensee may still be able to enforce confidentiality and other “passive” obligations.¹¹⁹

Timing is critical to whether a licensee may retain rights pursuant to section 365(n) because that section applies only to rights existing at the time the bankruptcy commences. The court in *In re Storm Tech., Inc.* held that contingent rights to IP will not be preserved by a licensee’s section 365(n) election: “The unambiguous language of § 365(n) limits the scope of the rights retained to those that existed immediately before the petition date.”¹²⁰ The contract at issue provided that if Storm Technology failed to pay a \$4 million note in full by a date certain, “Logitech will have a worldwide, non-exclusive royalty-free, fully paid-up license....”¹²¹ The court held that this “springing” license was a contingent IP right and as such was not within the scope of section 365(n) protection.¹²²

Section 363 and Sales of Intellectual Property by a Debtor-Licensor

¹¹⁵ 11 U.S.C. § 365(n)(2)(B)-(C); *Encino Bus. Mgmt. v. Prize Frize, Inc. (In re Prize Frize, Inc.)*, 150 B.R. 456, 458 (B.A.P. 9th Cir. 1993).

¹¹⁶ H.R. Rep. No. 1012, 100th Cong., 2nd Sess., at 9 (1988).

¹¹⁷ *In re Prize Frize, Inc.*, 150 B.R. at 460.

¹¹⁸ See, e.g., *Biosafe Int’l, Inc. v. Controlled Shredders, Inc. (In re Szombathy)*, Bankr. No. 94 B 15536, 1996 WL 417121, at *11 (Bankr. N.D. Ill., July 9, 1996), *rev’d on other grounds in Szombathy v. Controlled Shredders, Inc.*, No. 97 C 481, Bankr. No. 94B15536, 1997 WL 189314 (N.D. Ill. April 14, 1997).

¹¹⁹ *Id.*

¹²⁰ *In re Storm Tech., Inc.*, 260 B.R. 152, 157 (Bankr. N.D. Cal. 2001)(internal citations omitted).

¹²¹ *Id.* at 154.

¹²² *Id.* at 157.

A trustee in bankruptcy may enter into contracts “in the ordinary course of business” without the need for court approval.¹²³ In contrast, notice and a hearing are required before a trustee may enter into contracts that are not in the ordinary course of business.¹²⁴ As such, any contract for the sale of IP outside the ordinary course of a debtor’s business will require court approval.

Sections 363(b) & (f) allow a debtor-in-possession to sell the debtor’s assets free and clear of any third-party interest under certain conditions. Section 363(f) provides:

The trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate, only if

(1) applicable nonbankruptcy law permits sale of such property free and clear of such interests;

(2) such entity consents;

(3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;

(4) such interest is in bona fide dispute; or

(5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

In addition, section 1123(b)(4) of the Bankruptcy Code authorizes the sale of a debtor’s assets pursuant to a chapter 11 plan.

The interaction of the “free and clear” provisions of section 363 with the licensee’s election rights pursuant to section 365(n) can create complex issues regarding who owns what rights when the licensee opts to retain its use rights. A thorough analysis of this scenario is presented by the court in *In re Dynamic Tooling Systems*.¹²⁵ In this case, the debtor sought to transfer its entire IP portfolio to the subsidiary of a creditor.¹²⁶ The court characterized the creditor’s subsidiary’s acquisition of the debtor licensor’s assets as a sale pursuant to the debtor’s plan under section 1123(b)(4).¹²⁷ To the extent the sale was made free and clear of liens and

¹²³ 11 U.S.C. section 363(c)(1); *see also, e.g., In re Roth Am., Inc.*, 975 F.2d 949, 952 (3d Cir. 1992).

¹²⁴ *Id.*, citing section 363(b)(1).

¹²⁵ *In re Dynamic Tooling Sys., Inc.*, 349 B.R. 847, 855-56 (Bankr. D. Kan. 2006).

¹²⁶ *Id.* at 849.

¹²⁷ *Id.* at 855.

interests, that sale implicated section 363(f).¹²⁸ The court acknowledged the licensee’s fears that the transfer of IP assets would be free and clear of the licensee’s rights, despite the licensee’s rights to elect to continue use of the debtor’s intellectual property pursuant to section 365(n).¹²⁹

Noting a lack of case law directly on point, the court found that the licensee’s concerns could easily be resolved by the court’s use of its section 363(e) powers to limit or prohibit a sale free and clear of interests to protect those interests.¹³⁰ Ultimately, the court held that “[Licensee’s] interests can be protected by this Court’s express order that to the extent [debtor]’s intellectual property is included in the asset transfer, that property is subject to whatever license rights [licensee] may have under the Agreement.”¹³¹

While this approach provides protection for a licensee of “intellectual property” that fits within the section 101 (35A) definition, vigilance is important. Pursuant to section 363(e), the power invoked by the court to protect the licensee’s rights is triggered “on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased.” Therefore, licensees should pay close attention to licensor bankruptcy notices to make sure that all appropriate requests for protection are made to the court.

Another important source of rights for a licensee is Section 363(f), which provides, *inter alia*:

The trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate, only if—

(1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;

(2) *such entity consents*. . . .¹³²

Again, vigilance is critical for a licensee to preserve its rights. As noted in *FutureSource LLC v. Reuters Ltd.*, “[i]t is true that the Bankruptcy Code limits the conditions under which an interest can be extinguished by a bankruptcy sale, but one of those conditions is the consent of the interest holder, and lack of objection (provided of course there is notice) counts as consent.”¹³³

Bankruptcy of a Licensee

¹²⁸ *Id.*

¹²⁹ *Id.*

¹³⁰ *Id.* at 856.

¹³¹ *Id.*

¹³² Emphasis added.

¹³³ *FutureSource LLC v. Reuters Ltd.*, 312 F.3d 281, 285 (7th Cir. 2002).

A licensee in bankruptcy, like a licensor, may choose to assume, reject, or assume and assign its executory contracts, including IP licenses. A debtor-licensee will, however, have a somewhat different set of related considerations in bankruptcy than will a typical debtor-licensor. For example, section 365(n) is inapplicable when a debtor-licensee rejects a license—the licensor owns the underlying IP so there are no “use” rights that the licensor might need to retain—leaving fewer restrictions on the debtor-licensee in this regard. On the other hand, a licensee’s ability to assume and assign a license will vary greatly depending on the kind of IP that is at issue and the exclusivity of the rights conferred. Perhaps the most complex issue facing a licensee is whether it can assume a license outright—in some circuits, assumption is only possible if a hypothetical assignment would also be permissible.

Assignment of IP Licenses by Debtor Licensees

Whether an IP license can be assigned or not will depend on the type of license at issue. Licenses may be treated differently (assignable or non-assignable) based on the kind of IP that is at issue—for example, patent, copyright, or trademark rights—and may also be treated differently depending on whether the license is exclusive or non-exclusive.

Courts have found non-exclusive patent licenses to be non-assignable unless the patent owner consents. “It is well settled that a non-exclusive licensee of a patent has only a personal and not a property interest in the patent and that this personal right cannot be assigned unless the patent owner authorizes the assignment or the license itself permits assignment.”¹³⁴

Moreover, even though exclusive licenses confer a broader ability on the licensee to sue for patent infringement, most courts hold that exclusive patent licenses are also generally non-assignable absent consent. For example, the court *In re Hernandez* held that the licensor’s consent to assign the license would be required even for exclusive licenses.¹³⁵ While an exclusive licensee has a sufficient property interest to give standing to sue, that does not mean that the exclusive licensee can freely assign the license.¹³⁶ The court reasoned that if an exclusive licensee could assign that license, a patent holder would lose its control over the identity of its license holders whenever the license agreement provided the licensee with an exclusive right.¹³⁷ Because that result would render an exclusive license the equivalent of an outright patent assignment, such result would be inconsistent with federal case law that carefully distinguishes between the two.¹³⁸ This view has been adopted by other courts as well.¹³⁹ The *In*

¹³⁴ *Gilson v. Republic of Ireland*, 787 F.2d 655, 658 (D.C. Cir. 1986); *see also, e.g., Perlman v. Catapult Entm’t (In re Catapult Entm’t)*, 165 F.3d 747, 750 (9th Cir. 1999)(holding that nonexclusive patent licenses do not give rise to ownership rights and are not assignable over the objection of the licensor); *In re Access Beyond Tech.*, 237 B.R. 32, 44 (Bankr. D. Del. 1999)(holding that nonexclusive patent license is not assignable).

¹³⁵ *In re Hernandez*, 285 B.R. 435, 440 (Bankr. D. Ariz. 2002).

¹³⁶ *Id.*

¹³⁷ *Id.*

¹³⁸ *Id.* at 440-41.

re Hernandez approach does, however, allow assignment by the exclusive licensee if the licensor has “pre-consented” to such an assignment, though such assignment must strictly comply with the terms of such “pre-consent.”¹⁴⁰

Similarly, nonexclusive copyright licenses are generally not assignable.¹⁴¹ As with non-exclusive patent licenses, non-exclusive copyright licenses do not transfer any rights of ownership—such rights remain in the licensor.¹⁴² Accordingly, a nonexclusive license is personal to the transferee, and the licensee cannot assign it to a third party without the consent of the copyright owner.¹⁴³

On the other hand, case law regarding the assignability of exclusive copyright licenses is mixed. Some courts have indicated that an exclusive copyright licensee can assign that license, as was the case in *In re Golden Books Family Entm’t*.¹⁴⁴ There, the court found that under applicable copyright law, exclusive licenses convey an ownership interest to the licensee that allows the licensee to freely transfer its rights.¹⁴⁵ Therefore, copyright law did not prevent the assumption and assignment of the exclusive copyright license in question.¹⁴⁶

Other courts, however, have come to the opposite conclusion. For example, in *Gardner v. Nike*, the court analyzed the Copyright Act and held that copyright licensees cannot freely transfer rights even under an exclusive license.¹⁴⁷ The *Gardner* court noted that there is no indication that Congress intended to bestow upon exclusive licensees the right to sublicense the subject matter of their license.¹⁴⁸ Furthermore, while Congress was aware that prior to the 1976 Copyright Act licensees could not sublicense their right in an exclusive license, Congress nevertheless chose to limit exclusive licensees’ “benefits” under the 1976 Copyright Act to

(continued...)

¹³⁹ *ProteoTech, Inc. v. Unicity Intern., Inc.*, 542 F. Supp. 2d 1216, 1219 (W.D. Wash. 2008) (“This Court agrees with the [*In re Hernandez*] Court that the rationale for requiring actual or constructive consent of the licensor applies regardless of whether the license is exclusive or non-exclusive.”).

¹⁴⁰ *In re Hernandez*, 285 B.R. at 441.

¹⁴¹ See, e.g., *In re Patient Educ. Media*, 210 B.R. 237, 240-43 (Bankr. S.D.N.Y. 1997).

¹⁴² See, e.g., *MacLean Assocs., Inc. v. William M. Mercer-Meidinger-Hansen, Inc.*, 952 F.2d 769, 778-79 (3d Cir. 1991).

¹⁴³ See, e.g., *In re Patient Educ. Media*, 210 B.R. at 240.

¹⁴⁴ *In re Golden Books Family Entm’t, Inc.*, 269 B.R. 311, 319 (Bankr. D. Del. 2001).

¹⁴⁵ *Id.*

¹⁴⁶ *Id.*

¹⁴⁷ *Gardner v. Nike, Inc.*, 110 F.Supp. 2d 1282, 1287 (C.D. Cal. 2000).

¹⁴⁸ *Id.*

“protection and remedies.”¹⁴⁹ Therefore, the court held that the assignment of rights by the exclusive licensee was invalid.¹⁵⁰

With respect to trademarks, courts have held that “under applicable trademark law, trademarks are personal and non-assignable without the consent of the licensor.”¹⁵¹

Assumption of an IP License by a Debtor Licensee- Hypothetical Test vs. Actual Test

As mentioned above, the literal language of section 365(c) suggests that if a debtor-licensee cannot assign a contract, it cannot assume that contract. This is a strange and counter-intuitive result, with particularly serious potential consequences for debtor-licensees in bankruptcy.

Circuits have split on the proper interpretation of this language. The first interpretation, called the “hypothetical test,” adheres strictly to the plain statutory language in examining whether, hypothetically, the contract at issue could be assigned under applicable federal law.¹⁵² When applying the hypothetical test, courts do not consider what the debtor actually intends to do—merely assume the contract, or in fact assign it to a third party: “[I]f a contract could not be assigned under applicable nonbankruptcy law, it may not be assumed or assigned by the trustee [or the debtor in possession].”¹⁵³ Circuits adopting this approach include the Third, Fourth, Ninth and Eleventh.¹⁵⁴ The “hypothetical test” is potentially onerous because, as discussed above, many kinds of IP licenses are not assignable by the licensee, and are therefore not assumable.

Other circuits, including the First and Fifth, have rejected the “hypothetical” test in favor of an “actual test.” Under the “actual test,” section 365(c)(1) will apply only after “a showing that the nondebtor party’s contract will actually be assigned or that the nondebtor party will in fact be asked to accept performance from or render performance to a party—including the trustee—other than the party with whom it originally contracted.”¹⁵⁵ The court in *In re Leroux* captures the practical effects of this difference in approaches:

¹⁴⁹ *Id.*

¹⁵⁰ *Id.*

¹⁵¹ *N.C.P. Mktg. Group v. Blanks (In re N.C.P. Mktg. Group, Inc.)*, 337 B.R. 230, 237 (D. Nev. 2005), *aff’d*, *In re N.C.P. Mktg. Group, Inc.*, 279 Fed. Appx. 561 (9th Cir. 2008).

¹⁵² *In re Catapult Entertainment, Inc.*, 165 F.3d 747, 749-50 (9th Cir. 1999) (citing *City of Jamestown v. James Cable Partners, L.P. (In re James Cable Partners)*, 27 F.3d 534, 537 (11th Cir. 1994)); *In re West Elec. Inc.*, 852 F.2d 79, 83 (3d Cir. 1988); *Breeden v. Catron (In re Catron)*, 158 B.R. 629, 633-38 (E.D. Va. 1993); *RCI Tech. Corp. v. Sunterra Corp. (In re Sunterra Corp.)*, 361 F.3d 257, 266-67 (4th Cir. 2004).

¹⁵³ *Cinicola v. Scharffenberger*, 248 F.3d 110, 121 (3d Cir. 2001).

¹⁵⁴ *In re West Elec. Inc.*, 852 F.2d at 83; *In re Sunterra Corp.*, 361 F.3d at 266-67; *In re James Cable Partners*, 27 F.3d at 537; *In re Catapult Entertainment, Inc.*, 165 F.3d at 754-55.

¹⁵⁵ *Bonneville Power Admin. v. Mirant Corp. (In re Mirant Corp.)*, 440 F.3d 238, 248 (5th Cir. 2006).

Under the actual test... assumption will be denied only if performance of the assumed contract by the debtor in possession will in fact deprive the nondebtor party to the contract of the benefit of the bargain. Since the debtor is the very party with whom the nondebtor party contracted, it is usually quite difficult for the nondebtor party to persuade the court that performance by the debtor will eviscerate its contractual expectations.¹⁵⁶

At least two justices have indicated that the time for a Supreme Court resolution of this issue may be coming soon. Justice Kennedy, joined by Justice Breyer, issued a three-page statement on the issue to accompany the Supreme Court's denial of certiorari with respect to the *N.C.P. Marketing Group* appeal. Though Justice Kennedy voted to deny the review, his statement suggested that the issue is a "significant question." Justice Kennedy wrote:

The division in the courts over the meaning of §365(c)(1) is an important one to resolve for Bankruptcy Courts and for businesses that seek reorganization. This petition for certiorari, however, is not the most suitable case for our resolution of the conflict. Addressing the issue here might first require us to resolve issues that may turn on the correct interpretation of antecedent questions under state law and trademark-protection principles. For those and other reasons, I reluctantly agree with the Court's decision to deny certiorari. In a different case the Court should consider granting certiorari on this significant question.¹⁵⁷

Justice Kennedy's discussion of the hypothetical and actual tests in his statement suggests that he may be leaning toward the actual test. He characterized the actual test as aligning section 365 with "sound bankruptcy policy;" though noting that this alignment only comes "at the cost of departing from at least one interpretation of the plain text of the law..."¹⁵⁸

Conclusion

A party's ability to enforce its patent rights in litigation may be significantly impacted by an adverse party's decision to file for bankruptcy. The automatic stay adds additional complexity to litigation proceedings, potentially creating asymmetrical scenarios where one party can proceed but the other is stayed, and the need for judicial approval of settlements creates an additional layer of uncertainty for all parties concerned.

¹⁵⁶ *In re Leroux*, No. 92-20403-WCH, 1997 WL 375677, at *2 n.5 (Bankr. D. Mass., June 30, 1997).

¹⁵⁷ Statement of Kennedy, J., *N.C.P. Mktg. Group, Inc. v. BG Star Prods., Inc.*, 556 U. S. ____ (2009), On Petition for Writ of Certiorari to the United States Court of Appeals For the Ninth Circuit, No. 08-463, decided March 23, 2009.

¹⁵⁸ *Id.*

Similarly, a licensing party's bankruptcy may profoundly affect the rights of other parties. A debtor's ability to reject, assume, or assume and assign an IP license will vary greatly depending on the kind of IP at issue, whether or not the license is exclusive, and whether the debtor is the licensor or the licensee. In some contexts, the debtor has extraordinary latitude to decide among all options, while in other contexts, certain options are available only subject to the counterparty's rights or consent, or are prohibited altogether. A circuit split on the critical issue of the actual test versus the hypothetical test adds another source of variance with respect to the treatment of the parties to an IP license. Consideration of these issues as early as possible—ideally at the time that a license is drafted, and preferably pre-petition—and vigilance in monitoring the bankruptcies of licensing counterparties may mean the difference between retaining one's rights and having those rights extinguished.