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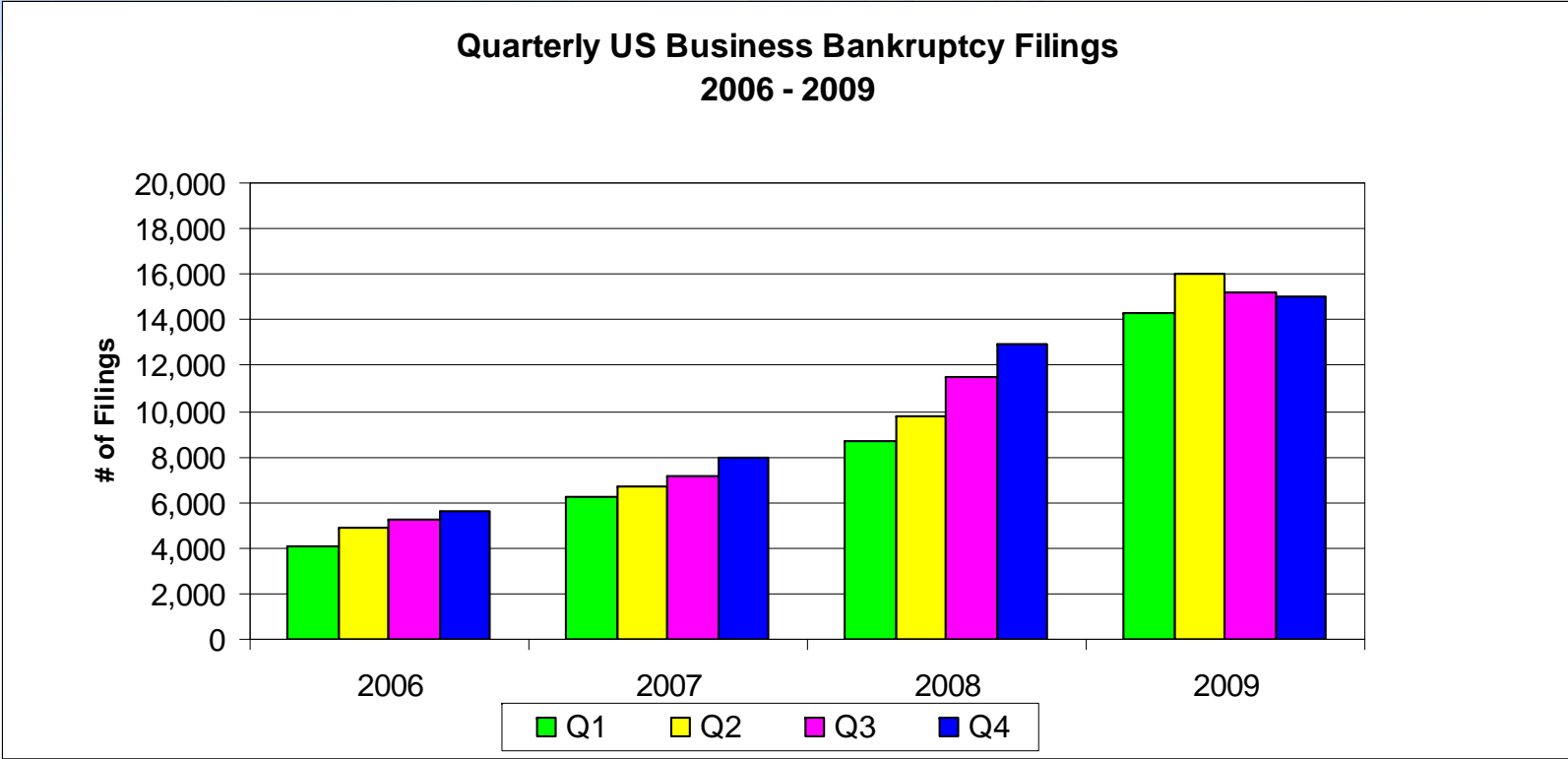


# Where's My Bailout?

The Impact of Bankruptcy on IP Litigation and Licensing

April 23, 2009

# Bankruptcy Statistics\*



\*Compiled by the American Bankruptcy Institute



# IP and Bankruptcy Policy Objectives

- Article I, Section 8 of the U.S. Constitution:
  - Patent, Copyright: “The Congress shall have power...to promote the progress of science and useful arts, by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries”
  - Trademark: “To regulate commerce...among the several states”
  - Bankruptcy: “To establish...uniform laws on the subject of bankruptcies throughout the United States”
- IP Law: Encourage and protect original expression and invention and prevent consumer confusion
- Bankruptcy Law: Rehabilitate debtor and maximize payments to creditors

# Background: The Petition

- Most bankruptcies voluntarily initiated by the debtor
- Filing a petition in bankruptcy creates a bankruptcy estate that includes all of the debtor's assets (11 U.S.C. § 541):
  - Real property
  - Intellectual property
  - Contract rights
  - Claims and causes of action

# Title 11: Bankruptcy

- ***Chapter 7: Liquidation***
- Chapter 9: Municipal bankruptcy
- ***Chapter 11: Reorganization***
- Chapter 12: Rehabilitation for family farmers and fisherman
- Chapter 13: Rehabilitation for individuals
- Chapter 15: Ancillary / International cases

# Background: Chapter 7 Liquidation

- Orderly wind-down of business / sale of assets
- Court-appointed trustee takes possession of assets and manages liquidation / payoff of creditors
- May recover some pre-bankruptcy transfers

# Background: Chapter 11 Reorganization

- Survival and rehabilitation of debtor
- Debtor in possession, although trustee can be appointed
- End goal: Confirmation of plan of reorganization
- Can liquidate under Chapter 11 or convert case to Chapter 7
- Bankruptcy Code provides a number of tools to help rehabilitate the Chapter 11 debtor

# Background: Key Provisions

- § 362: Automatic Stay
  - Litigation against debtor
  - Collection efforts
  - Actions against property of the estate
  - Setoff of debts
- § 363: Use, sale or lease of property
  - Most asset sales “free and clear of any interest in such property of an entity other than the estate....” 11 U.S.C. § 363(f).
- § 365: Executory contracts and unexpired leases
  - Gives debtor broad discretion to reject burdensome contracts and damages from rejection are treated as pre-petition claims

## § 362: Automatic Stay

- Gives the debtor a breathing spell from creditors
- Safeguards creditors' rights by preventing a "free-for-all"
- In cases against multiple defendants, claims against the debtor may be stayed while claims against the remaining defendants proceed
- If claims against all defendants are "hopelessly intertwined," the district court may exercise its discretion to stay the entire action

## § 362: Automatic Stay (cont'd...)

- § 362 (a): [A] petition filed...operates as a stay, applicable to all entities, of
  - (1) The commencement or continuation...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.
- Stays all court proceedings relating to **pre-petition** activities by the debtor

## § 362: Automatic Stay (cont'd...)

- Does not automatically stay proceedings relating to ***post-petition*** activities, including post-petition torts such as patent infringement
  - *Alloc, Inc. v. Unilin Decor N.V.*, No. 02-C-1266, 2005 WL 348060 (E.D. Wis. Dec. 15, 2005)(post-petition patent issuance)
- 28 U.S.C. § 959(a):

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.



## § 362: Automatic Stay (cont'd...)

- 28 U.S.C. § 959(a) provides court with discretion to stay even post-petition infringement claims if “necessary to the ends of justice”
  - *In re Telegroup, Inc.*, 237 B.R. 87, 95 (Bankr. D.N.J. 1999)(claim for damages for infringement during three-month post-petition window stayed).

## § 362: Automatic Stay (cont'd...)

- Bankruptcy usually helps the debtor by staying pre-petition infringement claims
- Bankruptcy can sometimes cut against the debtor with respect to post-petition infringement claims.
  - *Voice Sys. And Servs., Inc. v. VMX, Inc.*, 26 U.S.P.Q.2d 1106 (N.D. Okla. 1992)

## § 362: Automatic Stay (cont'd...)

- The automatic stay applies only to claims ***against*** the debtor (including counterclaims against the debtor)
  - *Maritime Elec. Co. v. United Jersey Bank*, 959 F.2d 1194, 1205 (3d Cir. 1991)(emphasis added)

## § 362: Automatic Stay (cont'd...)

- § 362(b)(4) provides an exception to the automatic stay:
  - “The filing of a petition...does not operate as a stay...of the commencement or continuation of ***an action or proceeding of a governmental unit...to enforce such governmental unit’s...police or regulatory power....***”
- Are Section 337 investigations before the International Trade Commission subject to the automatic stay?

## § 362: Automatic Stay (cont'd...)

- There is disagreement as to whether the § 362(b)(4) exception applies to ITC proceedings
- The ITC, in a Commission Opinion, has denied a bankruptcy debtor's request to stay an investigation
  - *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)
    - “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.” *Id.* at \*109-110.

## § 362: Automatic Stay (cont'd...)

- The Bankruptcy Court for the Eastern District of Virginia reached the opposite conclusion less than two months later
  - *In re Qimonda AG*, No. 09-14766-RGM, 2009 WL 2210771 (Bankr. E.D. Va. July 16, 2009)
  - The Administrative Law Judge adhered to the bankruptcy court's order staying the investigation
    - *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)

# Bankruptcy and Litigation Settlements

- Section 363(b):
  - (1) The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate...
- Federal Rule of Bankruptcy Procedure 9019(a):

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.

# Bankruptcy and Litigation Settlements

- Court must decide whether the compromise is fair, reasonable, and in the best interest of the estate
- Debtor must persuade the court that the settlement falls within the reasonable range of litigation possibilities
- Court usually defers to debtor's business judgment  
(*But see In re Spansion, Inc.*, No. 09-10690(KJC), 2009 WL 1531788 (Bankr. D. Del. June 2, 2009))

# Bankruptcy of a Licensor

- Licensor-Debtor's rights/concerns:
  - Affirm, transfer, or reject executory contracts such as most IP licenses (§ 365)
  - Sell IP assets (§ 363)
- Licensee's principal concern: Retaining rights to use Debtor's IP under existing licenses

# Executory Contracts (§ 365)

- Executory contracts: contracts “on which performance remains due to some extent on both sides.” *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 522 n.6 (1984)
- Common terms in most IP licenses render them executory even if “fully-paid-up”
  - Duties of confidentiality
  - Duties to give notice of lawsuits
  - Duties to defend IP against third-party validity challenges
  - Duty to decrease royalty if more favorable terms offered to a third party

# Executory Contracts (§ 365) (cont'd...)

## Debtor can assume, assign, or reject contract

- § 365 (a):

[T]he trustee, subject to the court's approval, may **assume or reject** any executory contract or unexpired lease of the debtor.

- § 365 (f):

Except as provided in subsections (b) and (c) of this section, **notwithstanding a provision in an executory contract** or unexpired lease of the debtor, or in applicable law, **that prohibits, restricts, or conditions the assignment of such contract** or lease, **the trustee may assign such contract** or lease under paragraph (2) of this section.



## Executory Contracts (§ 365) (cont'd...)

- In order to assume a contract, the debtor must:
  - Cure all defaults
  - Compensate non-debtor party for any actual loss resulting from any default
  - Provide adequate assurance of future performance
- In order to assign a contract, the debtor must first assume it (§ 365(f))
- The debtor has broad discretion to reject a contract
  - Absent bad faith or an abuse of business discretion, the court will allow rejection based on debtor's business judgment
  - A rejection is treated as a breach of the contract as of the petition date (§ 365(g))

## Executory Contracts (§ 365) (cont'd...)

- § 365(c) places certain limits on assumption and assignment
  1. “Applicable law excuses a party” from accepting or rendering performance from a party other than the debtor, **and** the non-debtor does not consent to the assumption or assignment;
  2. Contract is a loan, debt financing, or financial accommodations for the debtor; or
  3. Contract is a lease of non-residential real property that was terminated pre-petition.
- Limitation (1) impacts licensee-debtors more often than licensor-debtors

## Executory Contracts (§ 365) (cont'd...)

- **Problem:** What happens to licensee's rights if licensor rejects contract?
  - *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers*, 756 F.2d 1043 (4<sup>th</sup> Cir. 1985)
- Congress responded to *Lubrizol* by passing the Intellectual Property Licenses in Bankruptcy Act of 1988
  - Added provisions including §§ 365(n) and 101(35A) to the Code

## Executory Contracts (§ 365) (cont'd...)

- **§365(n)(1)**: If the trustee rejects an executory contract under which the debtor is a licensor of a right to *intellectual property*, the licensee under such contract may elect—
  - (A) to treat such contract as terminated...
  - (B) to retain its rights (including a right to enforce any exclusivity provision of such contract, but excluding any other rights 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.

## Executory Contracts (§ 365) (cont'd...)

- However, all intellectual property is not “intellectual property” under § 365(n)
    - §101(35A) The term “intellectual property” means—
      - (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.

## Executory Contracts (§ 365) (cont'd...)

- “Intellectual property” under § 365(n) does not include:
  - trademarks
  - service marks
  - trade names
  - rights of publicity
  - foreign patents
  - foreign copyrights

## Executory Contracts (§ 365) (cont'd...)

- If licensee retains rights under § 365(n), it must make all royalty payments due under the contract (§ 365(n)(2))
- Licensee does not retain ability to enforce any affirmative obligations under license (maintenance, support, development, *etc.*)
- Licensee may be able to enforce “passive” obligations (*e.g.*, confidentiality obligations)

## Executory Contracts (§ 365) (cont'd...)

- Considerations for Licensee:
  - Consider taking security interest in IP that is not “IP” under § 365(n) if feasible
  - Obtain presently effective license rather than springing license that becomes effective upon bankruptcy or other default
  - Avoid bundling license and support fees
  - Avoid bundling royalties for non-“intellectual property” under § 365(n)

## Executory Contracts (§ 365) (cont'd...)

- Consideration for Licensor:
  - Consider terminating prior to bankruptcy where feasible

## Use and Sales of Assets (§ 363)

- § 363 governs the use and sale of assets
- A trustee / DIP may enter into contracts “in the ordinary course of business” without court approval
- Notice and a hearing are required before a trustee may enter into contracts not in the ordinary course of business
  - Most IP licensing activity is not in the ordinary course of business

## Sales of Assets (§ 363)

- § 363 (f): The trustee may sell property...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;....[or]
  - (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.
- If requested by a licensee, the court may use its § 363(e) power to protect the licensee's interest
- Vigilance is critical; lack of objection = consent

## Sales of Assets (§ 363)

- Key Takeaway for Licensee: Object to any § 363 sale of licensed IP by debtor unless license is expressly preserved

# Bankruptcy of a Licensee

- Licensee's rights/concerns:
  - Affirm, transfer, or reject executory contracts such as most IP licenses (§ 365)
  - Can the licensee continue to use the licensed IP?
- Licensors own the licensed IP so is not typically concerned with retaining use rights if licensee rejects license

# Ipso Facto Clauses

- Bankruptcy Code generally voids Ipso Facto clauses.
  - § 365(e)(1): Notwithstanding a provision in an executory contract...an executory contract...of the debtor may not be terminated or modified, and any right or obligation under such contract...may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract that is conditioned on ---
    - (A) the insolvency or financial condition of the debtor at any time before the closing of the case;
    - (B) the commencement of a case under this title;....
  - See also § 363(l)

# Executory Contracts (§ 365)

- § 365(c) places certain limits on assumption and assignment:
  - (c) The trustee may not **assume or assign** any executory contract or unexpired lease of the debtor...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...; and
    - (1)(B) such party does not consent to such assumption or assignment....
- Intended to limit debtor's ability to assign personal services contracts without consent where prevented by applicable law

# Assignment of Licenses by Debtor-Licensees

- Whether a license can be assigned without the licensor's consent will depend on the type of license at issue:
  - Exclusive vs. non-exclusive
  - Type of licensed right (patent, copyright, trademark, *etc.*)

## Assignment of Licenses by Debtor-Licensees (cont'd...)

- Non-exclusive patent licenses are not assignable by licensee unless owner consents or license terms allow assignment
  - *Gilson v. Republic of Ireland*, 787 F.2d 655, 658 (D.C. Cir. 1986)

# Assignment of Licenses by Debtor-Licensees (cont'd...)

- Case law suggests that exclusive patent licenses are also generally non-assignable
  - *In re Hernandez*, 285 B.R. 435, 440 (Bankr. D. Ariz. 2002)
  - *ProteoTech, Inc. v. Unicity Intern., Inc.*, 542 F. Supp. 2d 1216, 1219 (W.D. Wash. 2008)(adopting *Hernandez* approach)

# Assignment of Licenses by Debtor-Licensees (cont'd...)

- Nonexclusive copyright licenses are generally not assignable
  - Nonexclusive copyright licenses do not transfer any rights of ownership—such rights remain in the licensor.
  - Thus, nonexclusive license is personal to the transferee, and the licensee cannot assign it without the consent of the copyright owner.

# Assignment of Licenses by Debtor-Licensees (cont'd...)

- Case law is mixed with respect to the assignability of exclusive copyright licenses
  - *In re Golden Books Family Entm't, Inc.*, 269 B.R. 311, (Bankr. D. Del. 2001)(permitting assignment without consent)
  - *Gardner v. Nike, Inc.*, 110 F.Supp.2d. 1282 (C.D. Cal. 2000)(not permitting assignment without consent)

## Assignment of Licenses by Debtor-Licensees (cont'd...)

- “Under applicable trademark law, trademarks are personal and non-assignable without the consent of the licensor.” *N.C.P. Mktg. Group v. Blanks (In re N.C.P. Mktg. Group, Inc.)*, 337 B.R. 230 (D. Nev. 2005), *aff'd*, *In re N.C.P. Mktg. Group, Inc.*, 279 Fed. Appx. 561, (9th Cir. 2008).

# Hypothetical Test vs. Actual Test

§ 365(c): The trustee may not ***assume or assign*** any executory contract or unexpired lease of the debtor...if...[applicable law prevents ***assignment*** without consent]

- Literal language of Section 365(c) states that if a debtor-licensee cannot assign a contract under applicable law, then it cannot assume the contract—***even if it has no intention of assigning it***
- “Hypothetical test” vs. “actual test”

# Hypothetical Test

- The “hypothetical test” applies the literal language of § 365(c)(1).
- “[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].” *Cinicola v. Scharffenberger*, 248 F.3d 110, 121 (3d Cir. 2001)
- Circuits adopting the hypothetical test include the Third, Fourth, Ninth and Eleventh.

# Actual Test

- The “actual test” looks to the actual intent of the debtor to either assume or assign the contract
  - *Bonneville Power Admin. v. Mirant Corp. (In re Mirant Corp.)*, 440 F.3d 238, 248 (5th Cir. 2006)
- Circuits adopting the actual test include the First and Fifth.

# Supreme Court Interest in Circuit Split

- 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:
  - “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. \* \* \* In a different case the Court should consider granting certiorari on this significant question.”

# Supreme Court Interest in Circuit Split

- Justice Kennedy’s statement of the tests suggests that he may be leaning towards the actual test:
  - Justice Kennedy characterizes the actual test as aligning § 365 with “sound bankruptcy policy,” though notes this alignment only comes “at the cost of departing from at least one interpretation of the plain text of the law....”

# Debtor-Licensee's Considerations

- File bankruptcy petition in an “actual test” jurisdiction if possible
- Consider including provisions permitting assignment in the license
  - Provision permitting assignment to an affiliate or related entity
  - Agreement that consent to assign not be unreasonably withheld

# Impact of Bankruptcy on IP Litigation / Licensing

Thank You

