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# Protecting the Rights of IP Licensors, Licensees in Bankruptcy

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On June 6th, the Eighth Circuit, acting en banc, reversed the 2012 decision of its own panel in the Chapter 11 bankruptcy case of Interstate Bakeries.[1] The 2012 decision had allowed the debtor to reject a perpetual royalty-free license of its trademark. The full panel reversed on the grounds that the license was not an executory contract since it had been granted as part of a larger asset purchase transaction in which the debtor had divested itself of manufacturing and distribution assets in certain geographic territories in order to comply with an antitrust judgment.

## The Problem

*Interstate Bakeries* is the latest of several decisions over the past few years that highlight the fundamental uncertainty that attends the disposition in bankruptcy of rights in intellectual property licenses, including not only the right of a licensee to use the intellectual property, but also the right of a licensor to control the identity of its licensee. Factually, *Interstate Bakeries* aligns with *Exide*, in which the Third Circuit[2] held that a perpetual royalty-free license granted as part of a prior sale of a part of the debtor's business was not an executory contract within the meaning of the Bankruptcy Code. But the dissenting opinion by three of the judges in *Interstate Bakeries* indicates that there is no bright line distinguishing executory and non-executory license agreements. Moreover, the courts are in fundamental disagreement over what it means to reject a license agreement.

*Lubrizol*,[3] decided by the Fourth Circuit nearly 30 years ago, held that the rejection of a license agreement by a debtor-licensor terminated the license, leaving the licensee with only an unsecured claim against the bankruptcy estate. *Lubrizol* prompted Congress to amend the Bankruptcy Code by adding §365(n), which allows licensees of intellectual property to preserve their license rights in the event of bankruptcy of the licensor. Since the amendment excluded trademarks from the definition of intellectual property, however, the rule established in *Lubrizol* left trademark licensees at risk of losing their license rights should their respective licensors file for bankruptcy. In the 2012

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case of *Sunbeam*,[4] the Seventh Circuit rejected *Lubrizol*, holding that a debtor-licensor's rejection of a trademark license agreement constituted a breach but did not terminate the licensee's right to use the trademark in accordance with the terms of the license.

*Lubrizol* and *Sunbeam* embody two fundamentally different interpretations of license rights. Under *Lubrizol*, the grant of a license acts as a continuous flow of permission that can be cut off by rejection. Conversely, under *Sunbeam*, the grant of a license acts as a prior transfer, subject to a reversionary interest. Since the Supreme Court denied the petition for certiorari in *Sunbeam*, the treatment of a trademark license in the bankruptcy of the licensor will, for the time being, depend upon where the bankruptcy proceeding is instigated, unless the licensee can convince the court that the license should be considered non-executory as was the case in *Interstate Bakeries* and *Exide*.

### International Complications

Even the relative certainty afforded by §365(n) to licensees of intellectual property other than trademarks may be called into question when the venue of the bankruptcy falls outside the United States. The recent case of *Jaffé v. Samsung*[5] had its origin in the bankruptcy of the German chip manufacturer Qimonda, a spinoff of Infineon, which was itself a spinoff of Siemens. Qimonda owned thousands of patents and, as is common in the electronics industry, had entered into cross licenses allowing the parties to pursue research and development without fear of infringement litigation. When Qimonda initiated insolvency proceedings in Munich in January 2009, however, its executory contracts, including the license agreements, were rendered automatically unenforceable under German law,[6] subject to review and possible later assumption by the insolvency administrator. The insolvency administrator filed for recognition of the German proceeding in a U.S. bankruptcy court under Chapter 15 of the Bankruptcy Code in order to take control of the licenses of the debtor's U.S. patents. The bankruptcy court recognized the German insolvency proceeding and the insolvency administrator as the foreign representative in the Chapter 15 proceeding. Acting on its own initiative, it also applied the whole of §365 to the U.S. proceeding, including §365(n), which was inconsistent with German law and the administrator's strategy of obtaining additional revenue from its licensees. When the administrator objected, the bankruptcy court initially removed the reference to §365(n) but the licensees appealed. Following remand by the district court, the case was heard by the Fourth Circuit Court of Appeals, which held that the bankruptcy court had reasonably exercised its discretion in balancing the interests of the debtor and the cross-licensees by applying §365(n).[7] The decision cited a provision in Chapter 15, which requires the bankruptcy court to determine that "the interests of the creditors and other interested entities, including the debtor, are sufficiently protected."[8] The opinion also includes dictum regarding the public policy exception in Chapter 15, which allows a court to refuse to take an action "manifestly contrary to the public policy of the United States."[9]

*Jaffé* raises serious questions about how far a U.S. court can go in changing the substantive outcome of foreign bankruptcy proceedings under Chapter 15. In applying §365(n), the court substituted the balance of interests crafted by Congress in the wake of *Lubrizol* for the balance applied by German law, thereby giving the licensees of the U.S. patents an advantage over other Qimonda licensees, whose licenses were revoked. In an amicus brief filed in the appeal to the Fourth Circuit, the U.S. Department of Justice argued that §365(n) has no bearing on the operation of German insolvency law and that the bankruptcy court should not attempt to resolve issues that might arise in future litigation between the parties if the administrator were to attempt to sell the U.S. patents under §363 of the Bankruptcy Code or to bring an infringement suit against the licensees. The implicit argument is that the application of the substantive requirements of §365(n) to a foreign bankruptcy proceeding upon the filing of an ancillary proceeding in the United States will create a disincentive to use the procedures of Chapter 15, thus frustrating efforts at procedural harmonization of bankruptcy law.

It remains to be seen whether the Supreme Court will weigh in on the issue, following the filing of a petition for certiorari on April 30, 2014. Even if the petition is denied, however, *Jaffé* does not provide a blueprint for future cases. As the brief of the licensees in opposition to the certiorari petition puts it: "The bankruptcy court did not hold that §365(n) will *always* apply… . In a case involving a different industry or different facts, [the] analysis could well change."[10] Compounding the uncertainty, a foreign administrator of an estate with substantial intellectual property assets might simply decline to request any discretionary relief or choose not to file a Chapter 15 case, leaving the question of the continued validity of rejected licenses for resolution in a later infringement action.

**Risks for Licensor**

The licensee is not the only party whose rights are put into uncertain limbo by the bankruptcy of its counterparty. The licensor will typically have an interest in maintaining control over the identity of its licensee, so most licenses restrict assignment by the licensee without the licensor's consent. Although §365(f)(1) of the Bankruptcy Code empowers a debtor or trustee in bankruptcy to assume and assign executory contract rights to third parties notwithstanding non-assignment provisions,[11] §365(c) creates a narrow exception to this general rule where applicable non-bankruptcy law would excuse the non-bankrupt party from accepting performance from a party other than the debtor.[12] This exception is generally held to apply to non-exclusive licenses of U.S. patents and copyrights, on the theory that allowing free assignment would undermine the federal policy of encouraging creation of inventions and original works of authorship by granting limited monopolies to inventors and authors.[13] In the case of trademark licenses, the requirement that a licensor exercise quality control over the licensee's use of its mark has generally been taken to imply that trademark licenses are inherently non-assignable.[14]

Although §365(c) will generally protect a licensor of intellectual property against having the license agreement assigned without its consent, it depends upon the interpretation of applicable non-bankruptcy law. If the license is governed by foreign law, the result may not be clear.[15] Moreover, even if the licensor's consent is generally required, not every license agreement will necessarily qualify. It has been suggested, for example, that an exclusive license agreement may be assignable in bankruptcy like other contracts, notwithstanding a non-assignment provision.[16] Following an amendment of the Copyright Act that included exclusive licenses in the definition of transfer of ownership, courts have held that an exclusive copyright license may be assigned by the licensee's bankruptcy estate without the licensor's consent.[17] The Ninth Circuit, however, came to a different interpretation of the Copyright Act in *Gardner*,[18] so an exclusive copyright licensor's ability to prevent assignment of its license will depend on the venue of its licensee's bankruptcy.

**Transactional Remedies**

Faced with this uncertainty, the parties to a license agreement have limited options for protecting themselves from their counterparty's bankruptcy. A licensee with leverage over its licensor could insist that the intellectual property be held by a special purpose vehicle to minimize the risk of bankruptcy altogether. For example, in a situation like that presented by *Exide* or *Interstate Bakeries*, where the owner of the mark is selling a division, the trademark could be transferred to a jointly controlled entity that would license it to the original owner and the purchaser for their respective territories or fields of use. Another option for an exclusive licensee would be to take a security interest in the licensed intellectual property. While holding a security interest won't secure its license rights as such, it would give the licensee substantial bargaining power in any bankruptcy proceedings. Another possibility for an exclusive licensee might be to structure the transaction as a partial assignment of the intellectual property. For example, when Qimonda was spun off from Infineon, Infineon retained certain rights in patents that it assigned to Qimonda rather than assigning them subject to a license back to itself. The German courts have so far held that the use of this structure effectively insulates the patent rights from the effect of rejection under the provision of German insolvency law that threatened the licensees' rights in *Jaffé*.[19]

From the licensor's perspective, the primary risk posed by bankruptcy of the licensee is the possibility that the trustee may assign the license to a third party without the licensor's consent. This risk is increased where the license is exclusive or the licensor fails to retain sufficient control over the licensed property, allowing the bankruptcy court to treat it as a de facto assignment rather than a license. To minimize this risk, the licensor might seek to structure the license as a non-exclusive license but agree not to exploit the intellectual property unless the licensee is in breach. Even if the licensee were amenable to such an approach, the licensee would lose the right to bring infringement suits in its own name, thus complicating the enforcement of licensed intellectual property rights.

The contractual means available to protect the rights of licensors and licensees from the uncertain effects of bankruptcy will not be available to most non-exclusive licensees or to parties lacking substantial leverage over their counterparties. Even if a party is in a position to push for certain contractual protections, these types of "protections" are cumbersome and may have other unintended consequences. Most importantly, a contractual strategy that works for one party may exacerbate the bankruptcy risk of the other party. For example, as mentioned above, the creation of a special purpose vehicle to hold trademark rights that are split up in the sale of a division may impede the licensor in exercising sufficient control over the licensed property to ensure that the transaction will be treated as a license rather than as a de facto assignment.

## A Possible Statutory Remedy

Since the licensor and the licensee have a common interest in ensuring that the fundamental terms of the license agreement are enforceable in the face of bankruptcy proceedings, there ought to be a better mechanism available to achieve the desired result. One promising candidate is recordation of the license agreement on the applicable intellectual property register.

The recordation mechanism is widely available for intellectual property licenses internationally. It is mandatory for all licenses in some countries, such as Egypt, and for exclusive licenses in others, such as Japan and Korea. Recordation is also available but not required for licenses of intellectual property in most other countries as well as for intellectual property registered with the World Intellectual Property Office.

In the United States, it is routine to record security interests with the U.S. Patent and Trademark Office even though recordation has been held to be unnecessary to perfect such interests.[20] Security interests in federally registered copyrights, on the other hand, must be recorded with the U.S. Copyright Office to be perfected.[21] While there is no requirement that license agreements be recorded, it is already possible to do so. The existing mechanism could be made more robust and useful by requiring recordation for the perfection of security interests not only in copyrights but also patents and trademarks, and permitting parties to licenses of federally registered intellectual property rights to perfect those rights—the licensee's right to exploit the intellectual property and the licensor's right to assignment of the license in accordance with the license terms—by recordation. Just as recordation of security interests typically involves the filing of a short form memorandum rather than the full security agreement, use of a similar memorandum of license would allow the parties to protect confidential license terms beyond the grant of the license itself.

The nearly universal availability of a mechanism to record licenses suggests that a similar provision could be incorporated into the UNCITRAL Model Law on Cross-Border Insolvency[22] to allow parties to a license agreement to perfect their interests in the agreement and avoid Qimonda-style uncertainty. There are, of course, crucial differences in intellectual property registration systems from one country to another that would prevent the use of recordation in some instances. For example, many countries do not maintain copyright registers on which licenses could be recorded. Other forms of intellectual property, such as trade secrets, are not registered at all. But adapting and strengthening the existing mechanism of recordation to allow the perfection of security interests and fundamental license rights in those intellectual property rights that are registered could bring a measure of certainty to intellectual property licensing and remove the need for cumbersome and contentious alternative means to avoid the risks of bankruptcy.

1. *In re Interstate Bakeries*, 447 B.R. 879 (Bankr. W.D. Mo. 2011), aff'd, 690 F.3d 1069 (8th Cir. 2012), rev'd on rehearing en banc 751 F.3d 955 (8th Cir. 2014).
2. *In re Exide Techs.*, 607 F.3d 957 (3d Cir. 2010), as amended (June 24, 2010).
3. *Lubrizol Enters. v. Richmond Metal Finishers*, 756 F.2d 1043 (4th Cir. 1985).
4. *Sunbeam Prods. v. Chicago Am. Mfg.*, 686 F.3d 372 (7th Cir. 2012).
5. 737 F.3d 14 (4th Cir. 2014).
6. German Insolvency Code, InsO §103.
7. *Jaffé v. Samsung Electronics*, 737 F.3d 14 (4th Cir. 2013).
8. 11 U.S.C. §1522(a).
9. 11 U.S.C. §1506.
10. Respondents' Brief in Opposition, filed July 2, 2014, p. 28.
11. 11 U.S.C. §365(f)(1).
12. 11 U.S.C. §365(c).
13. *In re CFLC*, 89 F.3d at 679; *In re Patient Educ. Media*, 210 B.R. at 243.
14. *Tap Publ'n v. Chinese Yellow Pages (New York)*, 925 F. Supp. 212, 218 (S.D.N.Y 1996).
15. See *XMH*, 647 F.3d at 695 (7th Cir. 2011), in which the court avoided analyzing the licensor's rights under Canadian law by finding a "universal rule" forbidding assignment in the absence of express authorization by the licensor.
16. *Perlman v. Catapult Entm't (In re Catapult Entm't)*, 165 F.3d 747, 752 (9th Cir. 1999), cert. dismissed, 528 U.S. 924 (1999).
17. *In re Golden Books Family Entm't*, 269 B.R. 311; *Traicoff v. Digital Media*, 439 F. Supp. 2d 872, 877-78 (S.D. Ind. 2006) (collecting authority).
18. *Gardner v. Nike*, 279 F.3d 774 (9th Cir. 2002).
19. OLG Munich, judgment of 25 July 2013, case 6 U 541/12.
20. *In re Cybernetic Servs.*, 252 F.3d 1039 (9th Cir. 2001); But see *Rhone-Poulence Argo, S.A. v. Dekalb Genetics*, 284 F.3d 1323 (Fed. Cir. 2002) (stating in dicta that a secured creditor should record its security interest with the U.S. Patent and Trademark Office to perfect its security interest against a bona fide purchaser or mortgagee). *In re Roman Cleanser*, 225 U.S.P.Q. 140 (Bankr. E.D. Mich. 1984), aff'd, 802 F.2d 207 (6th Cir. 1986) (recordation not necessary); *In re Together Dev.*, 227 B.R. 439 (Bank. D. Mass. 1998) (holding that recordation with the U.S. Patent and Trademark Office is a "trap for the unwary" as it is not legally necessary, nor sufficient, to perfect a security interest in a trademark).
21. *Peregrine Entm't v. Capitol Fed. Sav. & Loan Ass'n of Denver (In re Peregrine Entm't)*, 116 B.R. 194, 203 (C.D. Cal. 1990) ("Recording in the U.S. Copyright Office, rather than filing a financing statement under Article Nine [of the Uniform Commercial Code], is the proper method for perfecting a security interest in a copyright.").
22. Model Law on Cross-Border Insolvency (U.N. Comm'n on Int'l Trade Law 1997).