
# Intellectual Property Issues In Chapter 11 Bankruptcy Reorganization Cases

by David S. Kupetz

Chapter 11 of the Bankruptcy Code provides a framework for the reorganization of eligible entities.[1] Upon the filing of a Chapter 11 petition, a reorganization case is commenced and the debtor becomes a debtor-in-possession.[2] The filing of a Chapter 11 petition creates a bankruptcy estate which includes "all legal or equitable interests of the debtor in property as of the commencement of the case."[3] The debtor-in-possession continues to control and possess property of the estate and is authorized to manage and operate its business, unless and until otherwise ordered by the court.[4] Under 11 U.S.C. § 1107(a), a debtor-in-possession has virtually all the rights, powers and duties of a trustee. Chapter 11 reorganization cases involving bankruptcy estates, which include intellectual property assets, raise issues requiring special consideration. This article is designed to highlight selected issues arising in Chapter 11 cases involving intellectual property.

**Executory contracts**

*General bankruptcy law and underlying policies*

The primary goal of Chapter 11 is rehabilitation of the debtor. *See Eastern Airlines, Inc. v. International Assoc. of Machinists & Aerospace Workers, AFL-CIO, et al.* (*In re Ionosphere Clubs, Inc.*), 108 B.R. 901, 937 (Bankr. S.D.N.Y. 1989) ("The paramount policy and goal of Chapter 11, to which all other bankruptcy policies are subordinated, is the rehabilitation of the debtor."), *citing*

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*N.L.R.B. v. Bildisco & Bildisco*, 465 U.S. 513 (1984) ("The fundamental purpose of reorganization is to prevent a debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources."). Another predominant policy of bankruptcy law is equality of treatment of creditors with similar claims. *See Union Bank v. Wolas*, 112 S. Ct. 527, 533 (1991). In furtherance of this goal, there is a long-standing principle of bankruptcy law that a trustee (or debtor-in-possession in a Chapter 11 case) for the debtor's estate should not be compelled to assume (perform or pay) the debtor's obligations under a pre-bankruptcy contract that is executory and burdensome to the estate. *Bildisco & Bildisco*, 465 U.S. at 528 ("[T]he authority to reject an executory contract is vital to the basic purpose to a Chapter 11 reorganization, because rejection can release a debtor's estate from burdensome obligations that can impede a successful reorganization.").

Section 365 of the Bankruptcy Code provides that a debtor-in-possession or a trustee "may assume or reject any executory contract or unexpired lease of the debtor." 11 U.S.C. § 365(a). In the context of a bankruptcy case, the issue of whether a contract is executory is a question of federal law. *In re Qintex Entertainment, Inc.*, 950 F.2d 1492, 1495 (9th Cir. 1991), *citing In re Wegner*, 839 F.2d 533, 536 (9th Cir. 1988). However, the Bankruptcy Code does not define the term "executory contract." In the legislative history of section 365, Congress recognized that there is "no precise definition of what contracts are executory," but said that the definition "generally includes contracts on which performance remains due to some extent on both sides." H.R. Rep. No. 95-595, 95th Cong., 2d Sess. 347 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 6303. The Supreme Court has defined contracts as being executory when "performance remains due to some extent on both sides." *Bildisco & Bildisc*o, 465 U.S. at 523, n.6.

The definition of executory contract applied by most courts provides that an executory contract contains "obligations of both parties that are so far unperformed that the failure of either party to complete performance would constitute a material breach and thus excuse the performance of the other." *In re Qintex Entertainment*, 950 F.2d at 1495 (*quoting In re Wegner*, 839 F.2d at 536). This definition of executory contracts is the often cited definition offered by professor Vern Countryman. *See* Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 436, 460 (1973). Generally, a contract will be considered executory only if both parties still have material obligations that remain unperformed. *In re Qintex Entertainment, Inc.*, 950 F.2d at 1495; *In re AEG Acquisition Corp.*, 161 B.R. 50, 59 (Bankr. 9th Cir. 1993); *Encino Business Management, Inc. v. Prize Frize, Inc*. (*In re* Prize Frize, Inc.), 32 F.3d 426, 428 (9th Cir. 1994). Some courts have held that the correct time to determine whether or not a contract is executory for purposes of section 365 is as of the date of the filing of the bankruptcy petition. *See Vaughan v. Continental Airlines Holdings, Inc*. (*In re* Continental Airlines, Inc.), 154 B.R. 172, 174 (Bankr. D. Del. 1993). Other courts have held that the executoriness had to exist at the time of the court hearing on a motion brought pursuant to section 365. *See Cohen v. Drexel Burnham Lambert Group, Inc*. (*In re Drexel Burnham Lambert Group, Inc*.), 138 B.R. 687, 700 (Bankr. S.D.N.Y. 1992). In determining whether an agreement is an executory contract in the bankruptcy context, the courts examine the unperformed duties and obligations of each party. *In re Qintex Entertainment*, 950 F.2d at 1495.

The Ninth Circuit has held that a computer software licensing agreement is executory. *In re Select-A-Seat Corp*., 625 F.2d 290, 292 (9th Cir. 1980) (The licensee was obligated to pay the debtor/licensor five percent of annual net return from use of the software and the debtor was under a continuing obligation not to sell the software to third parties.). Similarly, in *University of Connecticut Research & Development Corp. v. Germain* (*In re* Biopolymers, Inc.), 136 B.R. 28, 29-30 (Bankr. D. Conn. 1992), the court held that an agreement allowing the debtor/licensee to use a patent regarding the production of certain material was an executory contract because the licensor had a continuing obligation both to forebear from granting licenses of the patent to others and not to withhold permission unreasonably for the licensee's sublicensing of the patent. *See also In re Wegner*, 839 F.2d at 537 (The duty to pay money by one party is a material obligation sufficient

to render a contract executory provided that corresponding materials obligations exist on the other side.). In *Lubrizol Enterprises v. Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.)*, the Fourth Circuit found an industrial processes licensing agreement executory. *Lubrizol Enters. v. Richmond Metal Finishers, Inc.* (*In re Richmond Metal Finishers, Inc.*), 756 F.2d 1043 (4th Cir. 1985), *cert. denied*, 475 U.S. 1057 (1986). The *Lubrizol* court held that the unperformed, continuing obligations of notice and forbearance in licensing made the contract executory for the debtor/licensor. The court found the contract executory for the licensee because it owed an unperformed and continuing duty of accounting for and paying royalties for the life of the agreement. The court also stated that the promise to account for and pay future royalties went beyond a mere debt, or promise to pay money, and was at the critical time executory.

Generally, courts have held that license agreements are executory contracts as long as the agreement has not been fully performed on both sides, or by either of the parties to the agreement. *See In re Qintex Entertainment*, 950 F.2d 1492 (An exclusive film license with a 25-year term was found to be executory because the licensee had the obligation to account and pay, and the licensor was required to refrain from licensing to others and to indemnify and defend the licenses from infringement.). Additionally, the court referred to the licensee's obligation to colorize the film and the licensor's obligation to exercise creative control over colorization. In *Qintex*, the Ninth Circuit cited *Select-A-Seat* and *Lubrizol* which were both cases holding that license agreements were executory contracts based on facts similar to *Qintex*, except for the colorization obligations. *See also In re* Three Star Telecast, Inc., 93 B.R. 310, 312 (D.P.R. 1988) (television program licensing agreement was an executory contract); *In re New York Shoes, Inc.*, 84 B.R. 947, 960 (Bankr. E.D. Pa. 1988) (trademark contract was executory); *In re Best Films & Video Corp.*, 46 B.R. 861, 869 (Bankr. E.D.N.Y. 1985) (movie distribution contracts were executory). However, courts have not universally found licensing agreements to be executory contracts. *See In re Learning Publications, Inc.*, 94 B.R. 736, 765 (Bankr. N.D. Fla. 1988); *In re Stein & Day, Inc.*, 81 B.R. 263, 267 (Bankr. S.D.N.Y. 1988). "*Learning Publications* and *Stein & Day* involved book contracts between a debtor/licensee and the author/licensor. Both contracts contained clauses: (1) giving the debtor broad publication and distribution rights; and (2) giving the author royalties and accounting rights....The authors had written the books and performed their contractual obligations as of the date of the bankruptcy filing. Both courts held that these book contracts did not constitute executory contracts because the author did not owe any remaining material duties to the debtor." *In re Qintex Entertainment*, 950 F.2d at 1495-96. The courts have found that agreements which constitute an outright conveyance of intellectual property rights (as opposed to traditional license agreements requiring an ongoing relationship involving mutual obligations between the parties) are not executory contracts. *See Chesapeake Fiber Packaging Corp. v. Sebro Packaging Corp.*, 143 B.R. 360, 374-75 (D. Md. 1992) ("Courts have consistently held that agreements conveying patent rights, even if they reserve continuing rights to the parties including the right of termination, constitute grants of title and are not executory in nature....This [the agreement at issue in this case] was not a license agreement but rather constituted an outright grant of title..."). *See also In re AEG Acquisition Corp.*, 161 B.R. 50, 59-60 (Bankr. 9th Cir. 1993).

Section 365 of the Bankruptcy Code allows a debtor-in-possession to reject burdensome obligations while permitting retention of those which have value to the estate. If there has been a default in an executory contract, the debtor-in-possession may not assume the contract unless it cures (or provides adequate assurance that it will promptly cure) such default, compensates (or provides adequate assurance of prompt compensation) for any pecuniary loss of the other party resulting from such default, and provides adequate assurance of future performance under the contract. 11 U.S.C. § 365(b)(1). If the debtor has reasonably exercised its business judgment in determining whether to reject or assume an executory contract, the debtor's decision will generally be approved by the court.

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*Lubrizol Enters.*, 756 F.2d at 1046, *citing Bildisco & Bildisco*, 465 U.S. at 523.

In a Chapter 11 reorganization case, a debtor-in-possession has until confirmation of a plan of reorganization to decide whether to assume or reject an executory contract, although a creditor may request that the bankruptcy court require the debtor to make such a determination within a specified period of time. 11 U.S.C. § 365(d)(2); *see Bildisco & Bildisco*, 465 U.S. at 529. Under 11 U.S.C. § 365(d)(2), courts may impose a reasonable deadline on the debtor-in-possession for determining whether to assume or reject an executory contract. *In re Whitcomb & Killer Mortgage Co., Inc.*, 715 F.2d 375, 378 (7th Cir. 1983). Courts have held that the determination of a reasonable time must be based on the facts and circumstances of the case at hand. *In re Beker Industries Corp.*, 64 B.R. 890, 896 (Bankr. S.D.N.Y. 1986).

The Bankruptcy Code provides that the rejection of an executory contract which had not been assumed constitutes a breach of the contract which relates back to the date immediately preceding the filing of the debtor's bankruptcy petition. 11 U.S.C. § 365(g)(1). *See also Lubrizol Enters.*, 756 F.2d at 1048 ("Even though § 365(g) treats rejection as a breach, the legislative history of § 365(g) makes clear that the purpose of the provision is to provide only a damages remedy for the non-bankrupt party....[T]he statutory 'breach' contemplated by § 365(g)...provides only a money damages remedy for the non-bankrupt party. Allowing specific performance would obviously undercut the core purpose of rejection under § 365(a), and that consequence cannot therefore be read into congressional intent.") A claim resulting from the rejection of an executory contract thus becomes a prepetition unsecured claim which must be presented through the normal claims administration process. 11 U.S.C. § 502(g). When the debtor-in-possession rejects a contract, the other party cannot compel performance. It can, however, assert a claim for damages that results from the rejection (breach). Damages generally will not make the other party whole because it will usually be paid only at the same pro-rata level as payments made to the general unsecured creditors in the bankruptcy case.

Section 365 applies generally, by its terms, to "an executory contract or unexpired lease of the debtor." 11 U.S.C. § 365(a). However, Congress has created exceptions to the general application of section 365 by adopting amendments to the section providing special treatment for certain kinds of executory contracts or unexpired leases. For example, 11 U.S.C. § 365 has been amended to provide special treatment for unexpired leases of real property in a shopping center, unexpired leases of nonresidential real property, and executory timeshare interests under a timeshare plan. 11 U.S.C. §§ 365(b)(3), (d), (h), (i). *See also* 11 U.S.C. § 1110 with regard to aircraft leases, leases of aircraft equipment, and leases of vessels. Additionally, Congress added section 1113 to the Bankruptcy Code to govern the rejection of collective bargaining agreements in response to the Supreme Court decision in *Bildisco & Bildisco* 465 U.S. 513 (1984). Congress subsequently added section 1114 regarding modification of payment of retiree benefits of employees of a debtor-in-possession. 11 U.S.C. §§ 1113, 1114. Similarly, following the Fourth Circuit's decision in *Lubrizol Enterprises*, the intellectual property community sought special protection to protect licensees of intellectual property from rejection of a license agreement by a debtor-in-possession or trustee. This special protection was embodied in Bankruptcy Code Section 365(n). 11 U.S.C. § 365(n).

**Bankruptcy Code Section 365(n)**

Congress enacted Bankruptcy Code Section 365(n) in 1988 to protect licensees and assignees of copyrights and other forms of intellectual property. This amendment was a reaction to the Fourth Circuit's holding in *Lubrizol Enterprises* that a technology licensor could unilaterally reject its license agreement under section 365 and eliminate the right of the licensee to use the intellectual property. The *Lubrizol* court recognized the harsh result of its holding and stated that Congress had afforded special treatment for certain types of executory contracts under the Bankruptcy Code, but that the Code did not contain any comparable treatment of technology licenses. *Lubrizol Enterprises*, 756 F.2d at 1048. By implementing 11 U.S.C. § 365(n), Congress sought to reverse the potentially chilling effect on the licensing of intellectual property as a result of the *Lubrizol* decision. H.R. Rep. No. 100-1012, 100th Cong., 2nd Sess. 6 (1988) (hereinafter "H.R. No. 100-1012") ("[P]roponents of the legislation argue that the *Lubrizol* case has had a chilling effect on licenses of intellectual property and that businesses are becoming reluctant to rely on licensed

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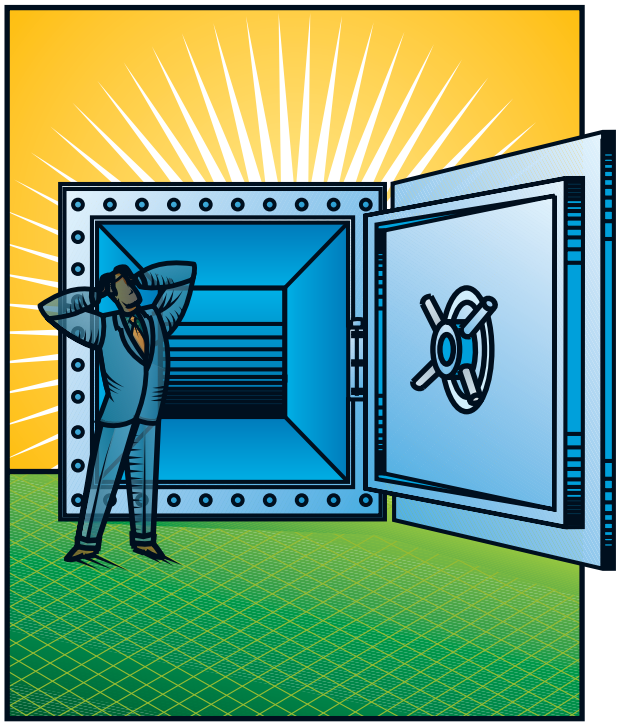
technology knowing that the license could be taken away if the licensor files bankruptcy. Licensees sometimes used the licensed technology as the basis for an entire business. As an example, a computer manufacturer may license microchip technology from another company and use it in the computers it manufactures. Proponents of the bill told the subcommittee at its hearing that the *Lubrizol* decision means that, if the licensor files bankruptcy, the licensor could reject its license agreement with the computer manufacturer and take back its technology, leaving the manufacturer without the technology necessary to make its product. In some fields, the licensee may not be able to obtain adequate substitute technology."). Congress designed 11 U.S.C. § 365(n) to allow the intellectual property licensee, upon rejection of the license agreement by the debtor/licensor, the option to either "retain its rights" in the intellectual property while continuing to pay royalties, or to treat the executory contract as terminated.



Section 365(n) of the Bankruptcy Code generally provides that when the debtor-in-possession rejects a license of intellectual property, the debtor/licensor is released from the performance of future obligations and the nondebtor licensee may elect to retain the licensed property. The Bankruptcy Code defines "intellectual property" to mean the following: (1) trade secret; (2) invention, process, design or plant protected under 35 U.S.C. § 1 *et seq*. (the patent laws); (3) patent application; (4) plant variety; (5) work of authorship protected under title 17 of the U.S. Code (the copyright laws); and (6) mask work protected under Chapter 9 of the copyright laws (part of the Semiconductor Chip Protection Act of 1984). 11 U.S.C. § 101(56). *See also* 11 U.S.C. § 101(57) for the definition of "mask work." Trademarks are not covered in the definition of "intellectual property" in the Bankruptcy Code.

Section 365(n) provides two options for the nondebtor technology licensee in the event that the debtor/licensor rejects the license agreement. 11 U.S.C. § 365(n)(1). The licensee is given a choice: (1) under 11 U.S.C. § 365(n)(1)(A), it can treat the contract as terminated if the rejection would constitute a breach if the licensor was not in bankruptcy (if the debtor/licensor's failure to comply with its remaining obligations under the license amounts to the type of breach that would allow the licensee to treat the license as terminated under applicable nonbankruptcy law); or (2) under 11 U.S.C. § 365(n)(1)(B), it can retain its rights under the agreement to use the licensed intellectual property for the duration of the contract period and for any extension periods provided for as a matter of right by nonbankruptcy law (which includes lawful renewal periods provided for at the licensee's option in the contract itself). 11 U.S.C. § 365(n)(1)(B); *see* H.R. No. 100-1012 at 8; s*ee also Encino Business Management, Inc. v. Prize Frize, Inc*. (*In re Prize Frize, Inc*.), 150 B.R. 456, 459 (Bankr. 9th Cir. 1993); *Encino Business Management*, 32 F.3d at 428; *In re El International*, 123 B.R. 64, 66 (Bankr. D. Idaho 1991); *In re Matusalem*, 158 B.R. 514, 521-22 (Bankr. S.D. Fla. 1993).

If the first choice is made, the licensee may assert a claim against the estate for damages caused by the rejection, as a breach of contract under 11 U.S.C. §§ 365(g) and 502(g). If the licensee chooses this option, the licensee forfeits any and all of its rights to continued use of the subject technology. The licensee may simply file a claim in the bankruptcy case for breach of contract damages. The claim will be treated as a prepetition, general unsecured claim. 11 U.S.C. §§ 365(g), 502(g).

In most instances it is likely that the second alternative allowed under 11 U.S.C. § 365(n) will be a more attractive choice for the nondebtor/licensee because, among other things, the licensee's right to use the licensed technology is preserved for the term of the contract, notwithstanding the debtor/licensor's rejection of the contract. Upon the licensor's rejection, 11 U.S.C. § 365(n)(1)(B) allows the licensee to retain its right to the technology under the contract and under any agreement supplementary to the license. The rights retained do not include a right to compel specific performance by the licensor under the contract — except for a right, to the extent that it exists in the agreement, to enforce any exclusivity provision of the contract. "In this manner, the licensor is relieved of any burdens to take additional affirmative actions under the contract such as a duty to provide training, maintenance, promotion, or

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updates to the licensee. The licensee is protected by being able to retain the ability to use the license in the intellectual property, but the licensor/debtor is not burdened with having to take future affirmative actions — some of which could deplete the bankruptcy estate at the expense of the general creditors — while trying to reorganize or make a fresh start." H.R. No. 100-10012, at 8. Under this scenario, the licensee will still retain an unsecured claim for damages from rejection, as a breach of contract under 11 U.S.C. § 365(g), although damages may be less if the licensee elects to proceed under subsection 365(n)(1)(B) rather than under subsection (n)(1)(A), since the licensee still retains its rights to the intellectual property under subsection (n)(1)(B). *Id*.


If the nondebtor/licensee chooses to continue to use the licensed technology notwithstanding the debtor/licensor's rejection of the license, the licensee must continue to pay all royalties due the licensor. 11 U.S.C. § 365(n)(2)(B). Further, the licensee waives any right of setoff under 11 U.S.C. § 365(n)(2)(C)(i) and any administrative expense claim allowable under 11 U.S.C. § 503(b). 11 U.S.C. § 365(n)(2)(C)(ii). Losing the setoff right results in the damage claim arising from the breach of contract being treated as a prepetition unsecured claim instead of reducing the licensee's royalty obligation dollar for dollar (which would be tantamount to a secured claim). *In re Prize Frize*, 150 B.R. at 459 (Bankr. 9th Cir. 1993) ("If the licensee elects to retain its rights under the contract, the licensee must make all royalty payments due under the contract and will be deemed to have waived any right of setoff it may have with respect to such contract and any claim under Section 503(b) arising from the performance of the contract."). *See also In re El International*, 123 B.R. at 66 (Bankr. D. Idaho 1991). However, the doctrine of recoupment should still apply. *See Newbury Electric, Inc. v. MCI Constructors, Inc*. (*In re Newbury Corporation*), 145 B.R. 998, 1000-01, (Bankr. 9th Cir. 1992) ("Under the doctrine of recoupment, a creditor may assert a countervailing claim against a debtor's claim if both claims arise out of the same transaction....The creditor's claim is essentially a defense to the debtor's claim against the creditor rather than a mutual obligation...[T]he recoupment doctrine has traditionally operated as an exception to the rule [in bankruptcy cases restricting setoffs]." (citations omitted)).

If the licensee elects to continue to use the licensed property pursuant to 11 U.S.C. § 365(n)(1)(B), the debtor/licensor is required to allow the licensee access to the intellectual property and may not interfere in any way with the licensee's rights pursuant to the license agreement and any supplementary agreement. 11 U.S.C. §§ 365(n)(3)(A), (B). It is incumbent upon the licensee to request in writing such cooperation of the licensor. 11 U.S.C. § 365 (n)(4).

The Bankruptcy Code does not contain a definition of the term "royalty payments." *In re Prize Frize*, 150 B.R. at 459 ("There is a paucity of authorities construing Section 365(n) and none addressing the scope of this term. In a nonbankruptcy context, while the term royalty is usually employed in a restricted sense to denote periodic payment based upon productivity for a use of intangible property, authorities also define the term broadly to mean money or compensation paid for the use of intangible property." (citations omitted)). In the recent case of *In re Prize Frize, Inc*., the Ninth Circuit Bankruptcy Appellate Panel (the "BAP") determined that the term "royalty payments" must be defined broadly to include any payment for the use of intellectual property, no matter how the payment is designated in the contract. *Id*. at 459-60. The Ninth Circuit Court of Appeals affirmed the BAP's holding in *In* re *Prize Frize* that all payments due for the use of intellectual property should be analyzed as "royalties" regardless of how the payments are labeled by the parties. *In re Prize Frize*, 32 F.3d at 429. The issue of whether "license fees" paid by a licensee for the use of technology, patents, and proprietary rights were "royalties" as that term is defined in the Bankruptcy Code was described by the Ninth Circuit as an issue of "first impression in any circuit." *Id*. The Ninth Circuit then followed the analysis applied by the BAP in this case and found that 11 U.S.C. § 365(n) was designed to balance the interests of the debtor/licensor and the nondebtor intellectual property licensee. *Id.* The Ninth Circuit Court of Appeals stated:

> Section 365(n) has struck a fair balance between the interests of the bankrupt and the interest of a licensee of the bankrupt's intellectual property. The bankrupt cannot terminate and strip the licensee of rights the licensee had bargained for. The licensee cannot retain the use of those rights without paying for them. It is

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> essential to the balance struck that the payments due for the use of the intellectual property should be analyzed as "royalties," required by the statute itself to be met by the licensee who is enjoying the benefit of the bankrupt's patents, proprietary property, and technology. As the BAP observed, the legislative history buttresses this common sense interpretation of "royalties" in the statute.

*In re Prize Frize, Inc.*, 32 F.3d 428. The Ninth Circuit Court of Appeals concluded that "the parties by their choice of names cannot alter the underlying reality nor change the balance that the Bankruptcy Code has struck." *Id.*, at 429. The licensee in *In re Prize Frize* attempted to argue before the Ninth Circuit Court of Appeals that it should not be required to pay for obligations of the debtor under the contract which were no longer being performed. The Court of Appeals stated that "[t]hese obligations raise the question whether it is proper to consider all of the license fees as royalties or whether some portion of the fees should be allocated to payment for the obligations assumed by the debtor." *In re Prize Frize*, 32 F.3d at 429. The licensee had failed to raise this argument before the Bankruptcy Court or the BAP and, therefore, the Ninth Circuit Court of Appeals found that it was too late to raise the argument and that the licensee's remedy would be limited to asserting an unsecured claim for breach of the entire license agreement under section 365(g) of the Bankruptcy Code. *Id*.

**Drafting suggestions designed to maximize the protections available under Section 365(n) for Intellectual Property Licensees**

As discussed above, in order for a licensee to be entitled to the protections of 11 U.S.C. § 365(n), the license agreement must: (1) involve a license of "intellectual property" as defined in 11 U.S.C. § 101(56); and (2) the agreement must be an executory contract. 11 U.S.C. §§ 101(52), 365(n). One way to completely avoid the risk of rejection of an executory contract for the intellectual property licensee in a bankruptcy case is for that party, if possible, to purchase the technology outright instead of merely taking it under a license agreement. This would eliminate the characterization of the intellectual property agreement as an executory contract subject to rejection under section 365. Understandably, the instances in which an outright purchase of intellectual property is feasible or warranted may be rare. Presumably, it would be too expensive for many potential licensees. Further, among other things, the licensor/owner may be unwilling to sell because it would lose control over its invention. When addressing the issues presented by a possible future bankruptcy and rejection of the license agreement under 11 U.S.C. § 365(n), the licensee should seek both to create disincentives for rejection of the agreement as an executory contract and to create protections in the event of rejection.

*1. Make Section 365(n) explicitly apply*

The addition of section 365(n) to the Bankruptcy Code was designed to increase the likelihood that an intellectual property licensee would receive the benefit of its bargain following the bankruptcy of a licensor with which it had contracted. H.R. No. 100-10012, at 6 ("The purpose of the legislation is to promote development and licensing in intellectual property by providing certainty to licensees in situations where the licensor files bankruptcy and seeks to reject the license agreement as an executory contract... L]icensees will have the assurance of being able to continue to use the licensed intellectual property after rejection, while debtor/licensors will still be able to free themselves of burdensome obligations by rejecting license agreements.... Under the legislation, any right in the license agreement giving the licensee an exclusive license will still be enforceable by the licensee, but other rights of the licensee cannot be specifically enforced. In this manner, rejection will not deprive the licensee of the use of the intellectual property, as happened in the *Lubrizol* case, but the licensor/debtor will, consistent with the general goal of Section 365, be relieved of the burdens of complying with the rejected agreement.").

Because the definition of "intellectual property" set forth in 11 U.S.C. § 101(56) is limited and restrictive in scope, the licensee should attempt to characterize the property which will be the subject matter of the agreement in the terms expressly set forth in 11 U.S.C. § 101(56). *See* 11 U.S.C. § 101(56). The licensee should require that the license agreement expressly

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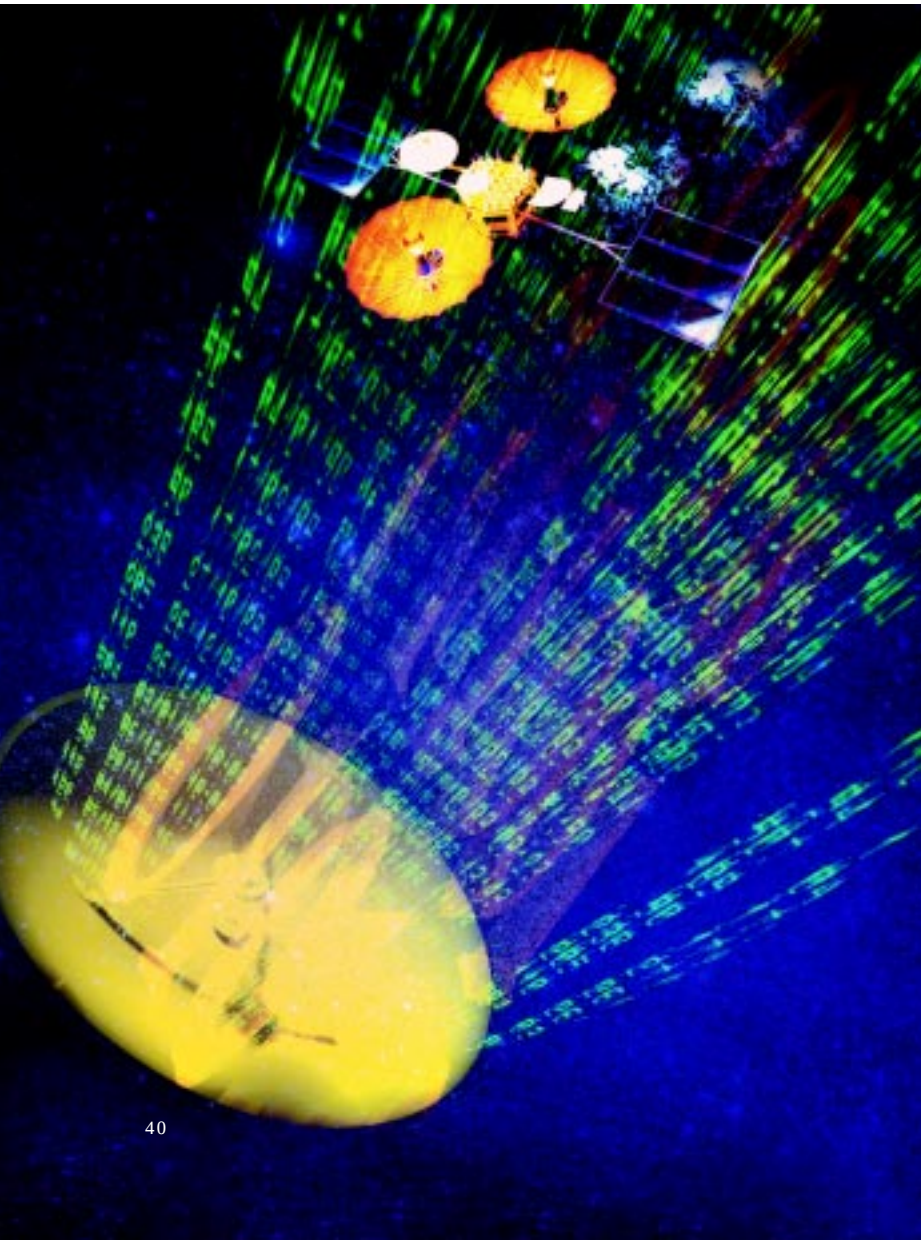
provides that the parties agree that the licensed property is "intellectual property" as defined in 11 U.S.C. § 101(56) and that the license agreement is governed by 11 U.S.C. § 365(n) in the event that the licensor commences a case under the Bankruptcy Code. Although these provisions may have questionable validity in a later bankruptcy case by the licensor, at a minimum, they should be of value in establishing the parties' intent at the time the agreement was negotiated and may serve as an admission in a future bankruptcy case.

Further, as discussed above, executory contracts for bankruptcy purposes involve situations where unperformed obligations remain on both sides of the agreement as of the date of the commencement of a bankruptcy case. In drafting a license agreement, the licensee should see that the agreement itself delineates, in significant detail, the scope and nature of the continuing obligations of both the licensor and the licensee over the life of the contract. In the event the licensor later commences a bankruptcy case, this should increase the likelihood that the agreement will be found to be an executory contract.



*2. Royalty provisions*

When a debtor/licensor rejects an intellectual property license and the licensee elects to continue to use the property, the licensee is required to continue to make "royalty payments" to the licensor. 11 U.S.C. § 365(n)(2)(B). However, while the licensor's rejection of the license agreement does not interfere with the licensee's continued use of the property, rejection permits the licensor to avoid its continuing affirmative obligations under the agreement which might include, for example, any obligation to train the licensee's personnel, to provide marketing service functions, product service, technical service, maintenance functions, defend against infringement, or the like. Thus, when drafting the license agreement, the licensee should specify the payments ("royalty payments") related to the use of the technology and segregate out those payments attributable to the performance of collateral obligations or services such as maintenance, training, marketing or other services. If the payments are lumped into one royalty payment, upon rejection by the debtor/licensor under 11 U.S.C. § 365(n), the licensee could be required to pay the full price for the collateral obligations even if they are not being performed. Thus, if the license is rejected, and the licensor discontinues performing collateral services such as maintenance, training, or marketing or other functions, if the licensee uses adequate care in drafting the agreement, it should not be obligated to make those payments attributable to such unperformed services. *See In re Prize Frize*, 150 B.R. at 460. The Ninth Circuit Court of Appeals points out that the licensee failed to raise before the lower courts the argument that it should not be obligated to make payments which were attributable to unperformed services. As a result, the Court of Appeals, found that it was too late for the licensee to raise the argument. *In re Prize Frize*, 32 F.3d at 429. The licensee should only have to make the payments related to the use of the intellectual property itself.

An alternative provision could provide for a royalty rate reduction which could explicitly provide that to the extent that a royalty payment for intellectual property is attributable to the licensor's performance of collateral obligations or services, the royalty shall be reduced a defined amount if the collateral obligations are not being performed. It must be kept in mind that provisions triggering a royalty rate reduction must be based on lack of performance and not tied to licensor's bankruptcy or insolvency because *ipso facto* clauses are unenforceable under the Bankruptcy Code. *See* 11 U.S.C. §§ 365(e)(1), 541(c)(1). Another option would be to structure a forfeiture of the royalty upon a defined event of

material breach (other than insolvency or bankruptcy). However, this drastic remedy is likely to be viewed as unenforceable even if not found to be an *ipso facto* provision.

*3. Assignment provisions*
Section 365(n) of the Bankruptcy Code governs the rejection of an intellectual property license agreement. However, this section does not provide for the assumption or assignment of such an executory contract. Under 11 U.S.C. § 365(f), notwithstanding any provision in the contract to the contrary, the debtor-in-possession may assign to a third party an executory contract if such contract is assumed and if "adequate assurance of future performance" by the assignee of such contract is provided. 11 U.S.C. § 365(f). The provisions governing assumption are 11 U.S.C. § 365(a), (b). With the exception of shopping center leases, 11 U.S.C. § 365(b)(3), what constitutes "adequate assurance of future performance" is not defined in the Bankruptcy Code. In preparing a license agreement, the licensee should attempt to define what constitutes adequate assurance of future performance if the license is ultimately assigned to a third party in a bankruptcy case. For example, it could be explicitly stated that any such assignee must affirmatively assume all of the debtor/licensor's obligations under the agreement and/or that certain net worth or capital requirements must be met by the licensee to ensure that the service, maintenance, marketing, research and development obligations originally bargained for can be fulfilled. While these kinds of provisions in prebankruptcy agreements may not be enforceable

*David S. Kupetz, Esq., a partner in Sulmeyer, Kupetz, Baumann & Rothman, is an expert in insolvency, business reorganization, and bankruptcy matters. He can be reached at dkupetz@skbr.com.*

in the event of a future bankruptcy filing by the licensor, they may provide evidence of the intent of the parties and may serve to help guide the Bankruptcy Court in addressing this issue if it ultimately arises.

*4. Define events of material breach*
As stated above, *ipso facto* clauses which trigger a default or remedy under the contract as a result of the debtor/licensor's insolvency or commencement of a bankruptcy case are unenforceable. Thus, the contractual language should refer to other events of default and remedies. The events which constitute a breach should be important to the licensee, such as a failure to perform a significant collateral obligation or an ancillary agreement. All such events should be specifically set forth in the contract.

**Limitation on assumption and assignment**
Bankruptcy Code Section 365 provides a bankruptcy trustee (or, in a Chapter 11 case, the debtor-in-possession) with the power to assume and assign executory contracts. Generally, the debtor-in-possession/trustee may take either of these actions without the consent of the other party to the contract and not withstanding any contrary provision in the applicable agreement that purports to restrict the assignment. *See* 11 U.S.C. §§ 365(a) and (f)(1). Once an executory contract has been assumed, the trustee/debtor-in-possession can assign it, subject to demonstrating adequate assurance of future performance by the assignee. 11 U.S.C. § 365(f). "This extraordinary authority, however, is not absolute." *Perlman v. Catapult Entertainment, Inc. (In re Catapult Entertainment, Inc.)*, 165 F.3d 747, 749 (9th Cir. 1998). Both section 365(a), which authorizes assumption, and section 365(f), which authorizes assignment, are subject to an exception provided in Bankruptcy Code section 365(c) that the debtor-in-possession/trustee may not assume or assign any executory contract where "applicable law excuses a party, other than the debtor, to such contract…from accepting performance from or rendering performance to an entity other than the debtor or the debtor-in-possession, whether or not such contract…prohibits or restricts assignment of rights or delegation of duties…and such party does not consent to such assumption or assignment…." 11 U.S.C. § 365(c). This section has been interpreted in a manner that significantly restricts the bankruptcy estate's ability to transfer and/or use certain intellectual property rights. *See Everex Systems, Inc. v. Cadtrak Corp. (In re CFLC, Inc.)*, 89 F.3d 673, 680 (9th Cir. 1996) ("Because federal law governs the assignability of nonexclusive patent licenses, and because federal law makes such licenses personal and assignable only with the consent of the licensor, the…license is not assumable and assignable in bankruptcy under 11 U.S.C. § 365(c)."); *see also In re Catapult Entertainment, Inc.*, 165 F.3d at 754-755 ("[W]here applicable nonbankruptcy law makes an executory contract nonassignable because the identity of the nondebtor party is material, a debtor-in-possession may not assume the contract absent consent by the nondebtor party.")

**Perfecting security interests in intellectual property**
The perfection of security interests in intellectual property is an area of the law which has been notable for its uncertainty and inconsistency with regard to the different requirements depending upon the type of intellectual property at issue. The primary question generally centers on whether the perfection of a security interest in intellectual property is governed by Article 9 of the Uniform Commercial Code ("UCC") even though intellectual property rights are created under federal law. Section 9109(c)(1) of the

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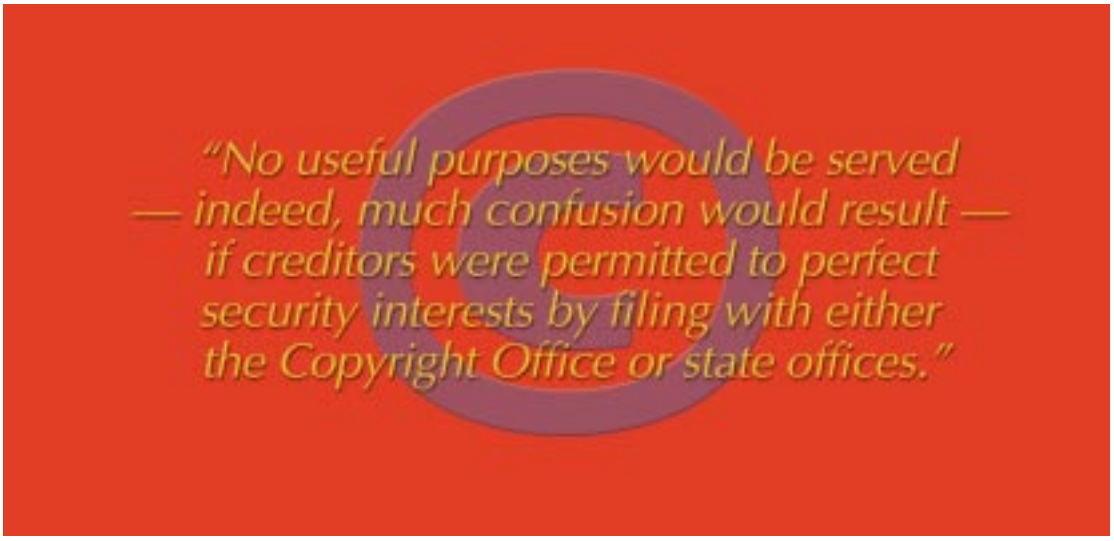
UCC provides that Article 9 does not apply to a security interest subject to a federal statute to the extent that such statute preempts Article 9. If the proper acts to perfect the security interest have not been taken in a bankruptcy case the debtor-in-possession or trustee can avoid (eliminate) the security interest under the "strong arm" avoiding powers of 11 U.S.C. § 544(a). Various cases have addressed the issues of perfection of security interests in intellectual property and federal preemption with regard to copyrights and trademarks. The safest approach is to file a UCC-1 with the appropriate Secretary of State under Article 9 and to also file with the applicable federal office (United States Patent and Trademark Office or United States Copyright Office).

**Copyrights**

In *In re Peregrine Entertainment, Inc*., 116 B.R. 194 (Bankr. C.D. Cal. 1990), Ninth Circuit Judge Kozinski, sitting by designation as a District Court Judge hearing an appeal from a decision of the Bankruptcy Court, addressed the issue of whether a security interest in a copyright is perfected by an appropriate filing with the United States Copyright Office or by a UCC-1 Financing Statement filed with the relevant Secretary of State. *In re Peregrine Entertainment*, 116 B.R. at 197. National Peregrine, Inc. ("NPI") was a Chapter 11 debtor-in-possession. NPI's principal assets were a library of copyrights, distribution rights and licenses to approximately 145 films, and accounts receivable arising from the licensing of these films to various programmers. *Id*. Capital Federal Savings and Loan Association of Denver ("Cap Fed") had made a $6-million loan secured by NPI's film library. Both the security agreement and the UCC-1 Financing Statements filed by Cap Fed described the collateral as "[a]ll inventory consisting of films and all accounts, contract rights, chattel paper, general intangibles, instruments, equipment, and documents related to such inventory, now owned or hereafter acquired by the debtor." *Id*. at 197-98. Although Cap Fed properly filed its UCC-1 Financing Statements with three appropriate states, it did not record its security interest in the United States Copyright Office. *Id*. After commencing a Chapter 11 case, NPI sought to avoid, recover and preserve Cap Fed's allegedly unperfected security interest for the benefit of the estate.




The matter came before Judge Kozinski on cross-motions for partial summary judgment on the question of whether Cap Fed had a valid security interest in the NPI film library. NPI's theory was that in order to perfect its security interest in the copyrights and related receivables Cap Fed was required to file its security interest with the Federal Copyright Office, and that its failure to make such a filing allowed NPI to seize the intangible assets under the strong-arm clause of 11 U.S.C. § 544(a). 11 U.S.C. § 544(a)(1) provides a trustee or a debtor-in-possession (if a trustee has not been appointed) with the rights and powers of a holder of a judicial lien to avoid security interests (among other transfers). Cap Fed argued that the copyrights and receivables were "general intangibles" under UCC § 9-106, and that its UCC-1 filings properly perfected its security interest.

Judge Kozinski found that a comprehensive scope of the Federal Copyright Act's recording provisions, along with the unique federal interests they implicate, supported the view that federal law preempts state methods of perfecting security interests in copyrights and related accounts receivable. *In re Peregrine Entertainment*, 116 B.R. at 199, 16 U.S.P.Q.2d at 1023. *See also In re AEG Acquisition Corp*., 127 B.R. at 41. The Copyright Act provides that "[a]ny transfer of copyright ownership or other document pertaining to a copyright" may be recorded in the United States Copyright Office and that a "transfer" under the Act includes any "mortgage" or "hypothecation of a copyright," whether "in full or in part" and "by means of conveyance or by operation of law." 17 U.S.C. §§ 205(a), 101, 201(d)(1). *See In re Peregrine Entertainment*, 116 B.R. at 198-99. The licensee and/or secured creditor should always record the license agreement to protect against avoidance under 11 U.S.C. § 544(a). The court found that a security interest in receivables generated by a copyright could also be recorded in the United States Copyright Office. *In re Peregrine Entertainment*, 116 B.R.

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at 199. While the court did not hold that the explicit language of the statute preempted UCC filing as a parallel method of perfecting security interests in copyrights and related receivables, the court found implicit federal preemption as a matter of public policy. *Id*. at 199-200 ("No useful purposes would be served — indeed, much confusion would result — if creditors were permitted to perfect security interests by filing with either the Copyright Office or state offices.").

The court stressed the need for uniformity in the recordation and perfection scheme at issue. The court cited the benefit of a single place where an interested third party can go to determine whether a particular copyright is encumbered. *Id*. at 200-02 ("A recordation scheme best serves its purpose where interested parties can obtain notice of all encumbrances by referring to a single, precisely defined recordation system. The availability of parallel state recordation systems that could put parties on constructive notice as to encumbrances on copyrights would surely interfere with the effectiveness of the federal recordation scheme. Given the virtual absence of dual recordation schemes in our legal system, Congress cannot be presumed to have contemplated such result. The court therefore concludes that any state recordation system pertaining to interests in copyrights would be preempted by the Copyright Act."). Some have argued that the court in *In re Peregrine Entertainment* goes further than it needed to. Further, Judge Kozinski found that the Copyright Act established its own scheme for determining priority among conflicting transferees and that this scheme differed in certain respects from that of Article 9 under the Uniform Commercial Code. Unlike Article 9, the Copyright Act permits the effect of recording with the Copyright Office to relate back as far as two months (17 U.S.C. § 205(d)). Accordingly, the court held that the availability of filing under the UCC would undermine the priority scheme established by Congress with respect to copyrights and that this type of direct interference with the operation of federal law weighed heavily in favor of preemption.

Judge Kozinski further concluded that state law also supported his conclusion regarding preemption. The court cited UCC §§ 9-302(3)(a) and (4) which provide that filing Article 9 Financing Statements with the Office of the Secretary of State in which a debtor is located is not "necessary or effective to preserve a security interest in property subject to...[a] statute or treaty of the United States which provides for a national or international registration...or which specifies a place of filing different from that specified in [Article 9]..." and that when a national system for recording security interests exists, the UCC treats compliance with that system as "equivalent to the filing of a financing statement under [Article 9], and a security interest in property subject to the statute or treaty can be perfected only by compliance therewith...." UCC §§ 9-302(3)(a), 9-302(4).

In reaching its conclusion that the Federal Copyright Act preempts the UCC, the court rejected two other federal district court decisions holding that, under the Federal Patent Statute, 35 U.S.C. § 261, secured lenders can perfect security interests in patents by filing financing statements covering "general intangibles" under Article 9 of the Uniform Commercial Code. *See City Bank & Trust Co. v. Otto Fabric, Inc*., 83 B.R. 780 (D. Kan. 1988); *In re Transportation Design & Technology, Inc*., 48 B.R. 635 (Bankr. S.D. Cal. 1985). Judge Kozinski held that while the patent cases reflect a more narrow view of federal preemption, they can be distinguished from cases involving copyright. Under the patent statute, a security interest not recorded in the Patent and Trademark Office is vulnerable only as against subsequent "purchasers" and "mortgagees," and not lien creditors such as a trustee in bankruptcy. *See In re Peregrine Entertainment*, 116 B.R. at 203-04; *In re Transportation Design & Technology*, 48 B.R. at 639; *City Bank & Trust Co.*, 83 B.R. at 782.

**Trademarks**

In *Joseph v. 1200 Valencia, Inc. (In re 199Z, Inc. )*, 137 B.R. 778 (Bankr. C.D. Cal. 1992), an asset purchase agreement was entered under which the purchaser pledged trademark assets as collateral for a portion of the purchase price. The seller recorded a memorandum of security agreement with the U.S. Patent & Trademark Office and filed a financing statement with the Secretary of State. *In re 199Z*, 137 B.R. at 779. The financing statement contained what was found to be a defective description by incorrectly stating that the seller, instead of the buyer, had granted the security interest. What occurred was that the seller had mistakenly attached as an exhibit to the UCC-1 filing a collateral description used as an exhibit in a UCC-1 Financing Statement executed by the seller in favor of its lender. The seller later corrected the exhibit to the financing statement pursuant to a UCC-2 Amendment. Thereafter, the purchaser filed a Chapter 7 Bankruptcy Petition and the seller became the defendant in a preference action brought by the trustee due to the filing of the UCC-2 Amendment within 90 days of the commencement of the bankruptcy case. *In re 199Z*, 137 B.R. at 779-80; *see* 11 U.S.C. § 547.

The Bankruptcy Court held that the trademark constituted a "general intangible" and that perfection was required in conformance with the Uniform Commercial Code. *In re 199Z*, at 781 ("The Uniform Commercial Code provides for perfection of a security interest through filing a financing statement conforming with its requirements with the appropriate secretary of state. In this manner, a security interest in 'general intangibles' can be perfected."). The Bankruptcy Judge cited the Uniform Commercial Code official comment to UCC § 9-106 where copyrights, trademarks and patents, come under the term "general intangibles" except to the extent that they may be excluded

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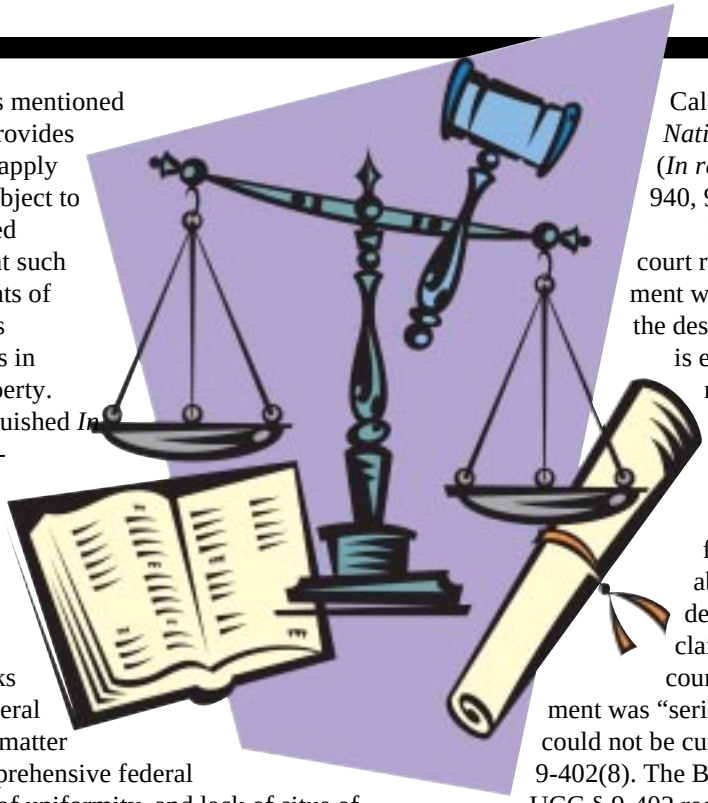
by UCC § 9-104(a). As mentioned above, UCC § 9-104 provides that Article 9 does not apply to a security interest subject to any statute of the United States, to the extent that such statute governs the rights of parties and third parties affected by transactions in particular types of property.



The court distinguished *In re Peregrine Entertainment*, recognizing that while many of the characteristics of copyright supporting federal preemption of state law were equally applicable to trademarks (such as the unique federal interests in the subject matter as shown through comprehensive federal legislation, promotion of uniformity, and lack of situs of the personal property because of its incorporeal nature), "one critical distinction exists between the federal legislation at issue in *In re Peregrine Entertainment* and the Lanham Act trademark legislation." *Id*. at 782. *See* 15 U.S.C. §§ 1051 *et seq.* (Lanham Act). The court held that while the Copyright Act provided expressly for the filing of any "mortgage" or "hypothecation" of a copyright including a pledge of the copyright as security or collateral for a debt, the Lanham Act provides expressly only for the filing of an assignment of a trademark, and the definition of "assignment" does not include pledges, mortgages, or hypothecations of a trademark. Therefore, the court concluded that the Lanham Act was different from the Copyright Act in that the granting of a security interest in a trademark is not the equivalent of an assignment of the trademark and that the filing in the Patent and Trademark Office was a nullity." *In re 199Z*, 137 B.R. at 782 ("Had Congress intended that security interests and trademarks be perfected by filing with the Patent Office, it could have expressly provided for such a filing, as it did in the Copyright Act."). The court found its conclusion to be harmonious with decisions holding that federal law does not preempt in the area of trademarks and that filing of a UCC-1 is necessary in order to perfect a security interest in such collateral. As a result, the court concluded that the recordation of the Memorandum of Security Agreement in the Patent Office did not perfect the seller's security interest in the trademark assets and that it would next consider whether the seller properly perfected its security interest in the trademark assets under California law. *Id., citing Creditors' Committee of TR-3 Indus., Inc. v. Capital Bank* (*In re* TR-3 Indus., Inc.), 41 B.R. 128, 131 (Bankr. C.D. Cal. 1984); *Roman Cleanser Co. v. National Acceptance Co. of America* (*In re Roman Cleanser Co*.), 43 B.R. 940, 944 (Bankr. E.D. Mich. 1984).

In applying California law, the court recognized that a financing statement which substantially complies with the description requirements of the UCC is effective even though it contains minor errors which are not seriously misleading. *In re 199Z*, 137 B.R. at 783, *citing* Cal. Comm. Code § 9402. However, the court held that "[t]o be effective, a financing statement must reasonably describe the property of the debtor in which the secured party claims an interest." *Id.* at 783. The court found that the financing statement was "seriously misleading" and, therefore, could not be cured as a minor error under UCC § 9-402(8). The Bankruptcy Court held that while UCC § 9-402 requires that the financing statement include "only the most basic description of property deemed to be collateral," *Id*., *citing Biggins v. Southwest Bank*, 490 F.2d 1304, 1307-08 (9th Cir. 1973). it must still contain some "reasonable description" of the property. Gill v. U.S. (*In re Boogie Enterprises, Inc*.), 866 F.2d 1172 (9th Cir. 1989).

The court held that the sellers' initial filing of the UCC-1 Financing Statement failed to completely describe the collateral of the Debtor in which the seller claimed a security interest. Therefore, the court found that the initial UCC-1 was ineffective to perfect a security interest in the trademark assets and that the Debtor's contention that the later UCC-2 Financing Statement amended a duly perfected security interest arising from the UCC-1 filing had no validity (seller had to make this argument in order to avoid admitting that the amended filing constituted a preference). In summary, the court found that neither the filing with the Patent and Trademark Office nor the UCC filings with the Secretary of State perfected the seller's claimed security interest in the trademark assets. *In re 199Z*, 137 B.R. at 784. The court cited *Webb Co. v. First City Bank* (*In re Softalk Publishing Co., Inc*.), 856 F.2d 1328, 1329 (9th Cir. 1988), as a "remarkably similar" case in support of the court's finding that the financing statement containing an inadequate description of the collateral is ineffective.

**Patents**

Under federal patent law, there is no recording required to protect the secured creditor against lien creditors such as a trustee in bankruptcy. *In re Transportation Design &*

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*Technology*, 48 B.R. at 639 ("[T]he grant of a security interest is not a conveyance of a present ownership right in the patent and, that like the creation of some other lesser rights in the patent (such as licenses) is not required to be recorded with the Patent Office."); *see also In re Cybernetic Services, Inc.*, 252 F.3d 1039 (9th cir. 2001. Thus, security interests in patents may be considered automatically perfected against a bankruptcy trustee as long as the security agreement and financing statement adequately identify the patents as collateral. *Id.* ("[A] bona fide purchaser holding a duly recorded conveyance of the ownership rights in a patent or a mortgagee who has recorded its interest as a transfer of title with the Patent Office will defeat the interests of a secured creditor of the grantor or mortgagor who has not filed notice of its security interest in the Patent Office. However, the trustee is in the position of a hypothetical lien creditor [11 U.S.C. § 544(a)(1)], not a *bona fide* purchaser."). If a secured creditor desires to protect itself against outright transfers to a bona fide purchaser or a mortgagee who properly records, a recording must be accomplished with the Patent and Trademark Office. *Id.*, 640 ("[I]f the secured creditor wishes to protect itself against the debtor transferring title to the patent to a bona fide purchaser or mortgagee who properly records, then the secured creditor must bring its security interest (which is not ordinarily a transfer of title) within the provisions of the Patent Act governing transfer of title to patents. Only in that way can its debtor be barred from transferring title until the debt is repaid.").

In *In re Transportation Design & Technology, Inc.*, the Bankruptcy Court addressed a trustee's attack against a secured creditor's security interest based on the creditor's failure to record a notice of its interest in the United States Patent and Trademark Office. The creditor had a valid security agreement and had filed a UCC Financing Statement describing "general intangibles." As indicated above, the court determined that the federal statute solely governed perfection as against bona fide purchasers and subsequent mortgagees. Further, as indicated above, the court held that the federal law did not displace the UCC, which controlled the relative rights of secured creditors and judgment lien claimants. The court recognized that it might appear anomalous that a secured creditor could properly perfect under the UCC and obtain perfection against other competing lien creditors and yet not be protected against a bona fide purchaser or mortgagee who recorded with the Patent and Trademark Office. *Id.* at 639-40.

The court went on to explain that a security interest has the following two purposes:

> First, it protects the interest of a secured creditor in collateral against subsequent or competing lien claimants of its debtor. Secondly, a security interest protects the secured creditor against the debtor transferring title to the collateral free of its interests. Ordinarily, perfecting a security interest in personalty in accordance with the UCC would protect both interests of the secured creditor. However, where a federal statute, such as the Patent Act, governs one area or interest which the secured creditor wishes to protect (e.g., ownership), then the federal statute preempts any other method of protecting that interest and is conclusive on the manner of protecting that interest.

*Id.* However, in *City Bank & Trust Co. v. Otto Fabric, Inc.* (*In re Otto Fabric, Inc.*), 55 B.R. 654, 657 (Bankr. D. Kan. 1985), the bankruptcy court rejected the holding of *In re Transportation Design & Technology* and concluded "that Patent and Trademark Office filing is an adequate filing system that entirely preempts UCC filing." This holding of the bankruptcy court was reversed on appeal in *City Bank & Trust Co.*, 83 B.R. at 782, where the district court held that "while the federal statute may preempt in part the system for perfecting security interests in patents, it is only a partial preemption. It leaves open a state filing to protect one's security interest in a patent against a lien creditor." (*citing In re Transportation Design and Technology*, 48 B.R. 635).

Although filing under the UCC would normally protect both interests of a secured creditor identified by the court, the court in *In re Transportation Design & Technology*, held that the Patent Act mandated an additional filing to completely perfect a security interest in a patent against subsequent bona fide purchasers (or mortgagees). Because the Patent Act did not expressly deal with the claims of other creditors, it did not govern

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their perfection or priority and the court rejected the trustee's attempt to avoid (as a hypothetical lien creditor under 11 U.S.C. § 544(a)(1)) the security interest at issue. *In re Transportation Design & Technology*, 48 B.R. at 639-40, applying *Waterman v. Mackenzie*, 138 U.S. 252 (1891). The court in *In re Transportation Design & Technology* summarized its holding regarding the effect of recordation in the federal or state office with regard to patent rights as follows:

> [I]f the secured creditor wishes to protect itself against the debtor transferring title to the patent to a bona fide purchaser or mortgagee who properly records [with the U.S. Patent Office], then the secured creditor must bring its security interest (which is not ordinarily a transfer of title) within the provisions of the Patent Act governing transfer of title to patents. Only in that way can its debtor be barred from transferring title until the debt is repaid. In most cases, the sophisticated lender lending on intellectual property is in the best position to decide which of its interests it wishes to protect and if sale or transfer of that property by the debtor is a substantial concern, it will perfect its security interests by recording an assignment, grant or conveyance of the patent with the Patent Office to prevent its transfer.
> *In re Transportation Design & Technology*, 48 B.R. at 640.

The court recognizes that this holding leaves a fairly narrow area remaining for state regulation. However, state law will still be required to resolve disputes and determine the relative rights of secured creditors and judgment lien claimants and between secured creditors, neither of whom have recorded with the Patent Office. In the absence of any overriding federal policy against it, the Uniform Commercial Code should continue to apply to the resolution of such matters.

**Conclusion**

The implications of a future bankruptcy case should be considered when preparing intellectual property agreements. This article has highlighted some issues which may arise in Chapter 11 cases involving intellectual property assets. Licensees of intellectual property should position themselves to take advantage of the benefits of 11 U.S.C. § 365(n) by seeking to create disincentives for the rejection of their license agreements and protections in the event of rejection. Parties seeking to perfect security interests in intellectual property should protect their interests by filing at the applicable federal office (United States Patent and Trademark Office or United States Copyright Office) as well as at the appropriate state offices. ▲

**Endnotes**

[1] *See* 11 U.S.C. §§ 101, *et seq.*
[2] 11 U.S.C. §§ 301, 1101(1).
[3] 11 U.S.C. § 541.
[4] 11 U.S.C. §§ 1107, 1108, 1104(a).