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Bankruptcy and Insolvency Issues

SUMMARY CONTENTS

US bankruptcy law can be invoked voluntarily or involuntarily when a company (a debtor) is unable to meet its obligations to its creditors. The law is designed to protect both debtors and creditors by modifying the relationship between a debtor's assets and its obligations. Two general types of bankruptcy proceeding are available under the US Bankruptcy Code: liquidation under Chapter 7 and reorganization under Chapter 11.[1]

In a Chapter 7 liquidation the debtor ceases all operations and its assets are collected and sold by a court-appointed trustee. The order in which the proceeds from this sale are distributed to the creditors depends on the type of debt owed. The filing of a bankruptcy proceeding initiates this process by creating a bankruptcy "estate" to which the debtor's property is transferred and assigning a trustee to manage the property. These actions are taken to protect the interests of the creditors during the pendency of the proceeding.

In contrast, under Chapter 11 the debtor continues to operate its business as a "debtor in possession" (DIP) with a fiduciary duty to maintain its assets for the benefit of its creditors. In the proceeding, the debtor's liabilities and obligations are reorganized in a manner that is designed to optimize the debtor company's ongoing value. As part of the proceeding, the debtor's plan of reorganization must be approved by both the creditors and the court. Once the proceeding is concluded, the debtor's business, obligations and debts are restructured and it may continue operations as an independent company.

21.1 AUTOMATIC STAY OF PROCEEDINGS

The filing of a bankruptcy petition in the United States triggers an automatic stay of most efforts to collect from, enforce rights against or take or use property of the bankruptcy estate.

[1] This chapter focuses exclusively on corporate bankruptcy and insolvency proceedings. Different rules apply to individual debtors in certain cases. Insolvency, which unlike "bankruptcy" is generally a matter of state law, means that the sum of the debtor's assets is less than the sum of its existing obligations (debts), or that the debtor is unable to pay its obligations as they become due.

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11 U.S.C. § 362(a): AUTOMATIC STAY

(a) Except as provided in subsection (b) of this section, a petition filed under [this title] operates as a stay, applicable to all entities, of –
  (1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;
  (2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;
  (3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;
  (4) any act to create, perfect, or enforce any lien against property of the estate;
  (6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;

The automatic stay under the Bankruptcy Code is a powerful tool. It demonstrates the priority that bankruptcy proceedings have over other actions, precluding otherwise lawful actions unless the actor obtains permission from the Bankruptcy Court. As explained by the Ninth Circuit, its purpose is "to give the debtor a breathing spell from creditors, to stop all collection efforts, and to permit the debtor to attempt repayment or reorganization."[2] Thus, any other legal actions that may impact a bankruptcy proceeding by removing property from the bankruptcy estate are frozen as of the date the proceeding commences.

Keep these principles in mind as you read the following case involving the automatic stay.

United States v. Inslaw, Inc.

932 F.2d 1467 (D.C. Cir. 1991)

WILLIAM, CIRCUIT JUDGE

Inslaw, Inc., after filing for reorganization under Chapter 11 of the Bankruptcy Code, invoked § 362(a) to secure bankruptcy court adjudication of … its prolonged dispute with the Department of Justice over the Department's right to use a case-tracking software system that Inslaw had provided under contract. Inslaw claimed that the Department had violated the stay provision by continuing, and expanding, its use of the software [PROMIS] in its U.S. Attorneys' offices [after the bankruptcy filing]. The bankruptcy court found a willful violation and the district court affirmed on appeal. [We reverse.]

[Inslaw's] major allegation concerns the Department's use of enhanced PROMIS after the filing of the bankruptcy petition. The bankruptcy court concluded first that the privately-funded enhancements to PROMIS were proprietary trade secrets owned by

[2] *Computer Comm. Inc. v. Codex*, 824 F.2d 725 (9th Cir. 1987).

Inslaw, and then that the Department's continued use of these enhancements, and in particular its post-petition installation of enhanced PROMIS in 23 U.S. Attorneys' offices (in addition to the 22 where Inslaw had made installations), were a "willful exercise of control over the property of the estate."

The automatic stay protects "property of the estate." This estate is created by the filing of a petition and comprises property of the debtor "wherever located and by whomever held," including (among other things) "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1) (1988). It is undisputed that this encompasses causes of action that belong to the debtor, as well as the debtor's intellectual property, such as interests in patents, trademarks and copyrights. The estate also includes property recoverable under the Code's "turnover" provisions, which allow the trustee to recover property that "was merely out of the possession of the debtor, yet remained 'property of the debtor.'"

In its brief, Inslaw refers rather vaguely to its interest in the enhanced PROMIS software as the "property of the estate" over which the Department supposedly exercised control. But for meaningful analysis, Inslaw's interests must be examined separately. One set of interests consists of (1) the computer tapes containing copies of the source and object codes that Inslaw sent to the Department on April 20, 1983 and (2) the copies of enhanced PROMIS that Inslaw installed on Department hardware between August 1983 and January 1984. As to these, Inslaw held no possessory interest when it filed for bankruptcy on February 7, 1985. Nor can it claim a possessory interest over them through the Code's turnover provisions, [because] as Inslaw freely admits, the Department held possession of the copies under a claim of ownership (its view of the contract …) and claimed the right to use enhanced PROMIS without further payment. [A] debtor cannot use the turnover provisions to liquidate contract disputes or otherwise demand assets whose title is in dispute. Indeed, Inslaw never sought possession of the copies under the turnover provisions.

The bankruptcy court instead identified the relevant property as Inslaw's intangible trade secret rights in the PROMIS enhancements. It then found that the Department's continuing use of these intangible enhancements was an "exercise of control" over property of the estate.

If the bankruptcy court's idea of the scope of "exercise of control" were correct, the sweep of § 362(a) would be extraordinary – with a concomitant expansion of the jurisdiction of the bankruptcy court. Whenever a party against whom the bankrupt holds a cause of action (or other intangible property right) acted in accord with his view of the dispute rather than that of the debtor-in-possession or bankruptcy trustee, he would risk a determination by a bankruptcy court that he had "exercised control" over intangible rights (property) of the estate.

[Such] assertions of bankruptcy court jurisdiction raise severe constitutional problems. Even apart from constitutional concerns, Inslaw's view of § 362(a) would take it well beyond Congress's purpose. The object of the automatic stay provision is essentially to solve a collective action problem – to make sure that creditors do not destroy the bankrupt estate in their scramble for relief. Fulfillment of that purpose cannot require that every party who acts in resistance to the debtor's view of its rights violates § 362(a) if found in error by the bankruptcy court. Thus, someone defending a suit brought by the debtor does not risk violation of § 362(a)(3) by filing a motion to dismiss the suit, though his resistance may burden rights asserted by the bankrupt. Nor does the filing of a *lis pendens* violate the stay (at least where it does not create a lien), even though it alerts prospective buyers to a hazard and may thereby diminish the value of estate property. And the commencement and continuation of a cause of action against the debtor that arises post-petition, and so is not stayed by § 362(a)(1), does not violate § 362(a)(3). Since willful violations of the stay expose the offending party to liability for compensatory damages, costs, attorney's fees, and, in some circumstances, punitive damages, see 11 U.S.C. § 362(h) (1988), it is difficult to believe that Congress intended a violation whenever someone already in possession of property mistakenly refuses to capitulate to a bankrupt's assertion of rights in that property.

[Our] understanding of § 362(a) does not expose bankrupts to any troubling hazard. Here, for example, Inslaw retains whatever intangible property rights it had in enhanced PROMIS at the time of filing. If the Department has violated the [contract,] Inslaw as debtor-in-possession has all the access to court enjoyed by any victim of a contract breach by the United States government. If [the alleged modification of the contract] was induced by fraud, [then] Inslaw has its contract remedies or perhaps a suit for conversion. Assuming that its privately-funded enhancements to PROMIS qualify as proprietary trade secrets, [it] may be able to sue the government under the Trade Secrets Act or even under the Administrative Procedure Act for improper disclosures of its trade secrets by government officials.

[Because] the Department has taken no actions since the filing of the bankruptcy petition that violate the automatic stay, the bankruptcy court must, as both a statutory and constitutional matter, defer to adjudication of these matters by other forums. So ordered.

Notes and Questions

1. *The* Inslaw *saga*. The *Inslaw* decision excerpted above is just one small piece in a sprawling legal dispute that improbably combines software licensing with international espionage, illicit arms deals and government cover-ups. According to Inslaw, the Department of Justice played a significant role in forcing the company into bankruptcy, which led to the above litigation regarding the DOJ's rights following Inslaw's filing. According to news reports, television programs and fragments of the case record, Inslaw licensed its PROMIS software to the US Department of Justice (DOJ) to help prosecutors monitor case records. But the DOJ, possibly with the help of the National Security Agency (NSA), modified the software without Inslaw's permission to enable it to spy on its users. The DOJ, possibly in coordination with high-ranking officials of the Reagan Administration, then allegedly distributed copies of the software to US allies, including the UK, Israel and Australia, using it to collect information surreptitiously from these countries.[3]
2. *Exercise of control*. The Bankruptcy Court in *Inslaw* found that the DOJ's continued use of the proprietary PROMIS software after Inslaw's bankruptcy filing constituted an "exercise of control" over Inslaw's trade secrets, which was subject to the automatic stay. The DC Circuit reversed, holding that the DOJ's use of property was *not* the exercise of control over that property. Given this holding, what kind of activity *would* constitute the attempted exercise of control of a software program licensed by the debtor to a third party?
3. *Post-petition actions not stayed*. In *Inslaw*, the court notes that the automatic stay does not prohibit a defendant from defending against a suit brought by the debtor-in-possession, nor

[3] Ryan Gallagher, *Dirtier than Watergate*, New Statesman, April 20, 2011.

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does it prohibit "the commencement and continuation of a cause of action against the debtor that arises post-petition." By the same token, the court suggests that Inslaw could bring a post-petition action for damages or intellectual property infringement against the DOJ for its unauthorized use of the PROMIS software. Even so, the DOJ's use of the software, even if unauthorized, does not fall within the scope of the automatic stay in bankruptcy.

4. *Actions barred*. In *Computer Communications, Inc. v. Codex Corp.*, 824 F.2d 725 (9th Cir. 1987), CCI and Codex were parties to a contract whereby Codex would purchase computer equipment from CCI. Shortly after CCI filed for bankruptcy, Codex sought to terminate the agreement in accordance with its terms. Among other things (see Section 21.5 for a discussion of the rule against *ipso facto* bankruptcy clauses), CCI argued that Codex was barred by the automatic stay from terminating the contract without permission of the bankruptcy court. The Ninth Circuit agreed with CCI, holding that the termination of a contract constituted an attempt to exert control over an intangible asset of the debtor (the contract). It explained:

> The legislative history emphasizes that the stay is intended to be broad in scope. Congress designed it to protect debtors and creditors from piecemeal dismemberment of the debtor's estate. The automatic stay statute itself provides a summary procedure for obtaining relief from the stay. All parties benefit from the fair and orderly process contemplated by the automatic stay and judicial relief procedure. Judicial toleration of an alternative procedure of self-help and post hoc justification would defeat the purpose of the automatic stay. Accordingly, we affirm the bankruptcy and district courts on the ground that Codex violated the automatic stay by unilaterally terminating the contract …

5. *Congressional intent*? The court in *Inslaw* notes that "it is difficult to believe that Congress intended a violation [of the automatic stay] whenever someone already in possession of property mistakenly refuses to capitulate to a bankrupt's assertion of rights in that property." What situation was the court referring to?

Problem 21.1

Which of the following actions would most likely be permitted in view of the automatic stay created by the debtor's filing for bankruptcy?

a. A licensor delivers the debtor a notice terminating a copyright license one day prior to filing for bankruptcy.
b. A licensor files an action in state court, one week after the debtor's filing for bankruptcy, seeking an injunction against the debtor who has licensed the licensor's trademarks and trade name.
c. A licensor files a lawsuit for patent infringement against the debtor one week prior to the debtor's filing for bankruptcy.

21.2 THE BANKRUPTCY ESTATE

As noted above, filing a bankruptcy petition causes an immediate and automatic transfer of all the debtor's "property" into the bankruptcy estate. This transfer has an immediate impact on entities dealing with the debtor and can substantially change the terms on which their relationship was built. Since the goal of a bankruptcy proceeding is to maximize value for creditors, the description of "property" included in the bankruptcy estate is broad.

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Section 541(a) of the Bankruptcy Code provides that the bankruptcy estate "is comprised of … all legal or equitable interests of the debtor in property as of the commencement of the case [and various designated types of property acquired after commencement of the case]." The key point in time for this purpose is thus the commencement of the bankruptcy case.

"Property of the estate" generally includes intellectual property (IP) rights, license rights, lawsuits and all other tangible and intangible assets of potential value at the time of a bankruptcy filing, as well as all "proceeds, product, offspring, rents, and profits of or from property of the estate." The definition of proceeds is quite important in determining what assets the creditors have access to.

Thus, in *Keen, Inc. v. Gecker*, 264 F. Supp. 659 (N.D. Ill. 2003), the court held that a patent application pending at the time of a bankruptcy filing was the property of the bankruptcy estate, as were any royalties earned after the patent issued (i.e., as "proceeds" arising from that property). In contrast, if the debtor begins a new line of research *after* the bankruptcy filing, and that research leads to an important new discovery that the debtor patents, that patent and its proceeds would *not* form part of the bankruptcy estate, as they arose after the filing.

The question of what assets are included in the bankruptcy estate is important for several reasons, including the degree to which the creditors of the bankrupt debtor are entitled to receive the proceeds of those assets.

Problem 21.2

Spendthrift Corp. is a producer of industrial chemicals. Suppose that in January 2013, Spendthrift discovers and files a patent application for a new nontoxic solvent. In December 2014, Spendthrift then files for reorganization under Chapter 11 of the Bankruptcy Code. The patent issues in March 2015, and in April the DIP licenses the patent to Ajax Corp. for an up-front royalty of $1 million. In June 2015, the DIP sells the patent to Bromide Corp. for $2 million. In August 2015, the DIP hires Rita Reagent, a world-renowned chemist. Rita immediately invents a heat-resistant lubricant compound and the DIP files a patent application on the invention. The lubricant patent issues in record time in July 2016. The DIP then sells this patent to Lubrizol, Inc. for $3 million. In October 2016, the DIP enters into a consulting agreement with Bromide relating to the manufacture of solvents made using the technology claimed in the 2015 patent. Which assets are included in Spendthrift's bankruptcy estate, and which are not?

21.3 EXECUTORY CONTRACTS AND SECTION 365(n)

Among the debtor's assets and property that are transferred to the bankruptcy estate are contract rights that existed at the time of filing for bankruptcy. However, in the case of contracts that have not been fully performed at the time of filing (so-called "executory" contracts), Section 365 of the Bankruptcy Code gives the trustee in bankruptcy or the debtor in possession the right to choose whether or not to assume such contracts.

The purpose of this powerful right is to allow the trustee to maximize the value of the estate's assets. As such, it may assume those contracts that would be beneficial to the debtor, while rejecting those that would be burdensome or uneconomical to perform.

If a contract is assumed, the responsibilities of the contract may be retained or assigned by the trustee, subject to court approval. If a contract is rejected, the debtor ceases its performance. Such nonperformance may constitute a breach of the contract, leaving the other contracting party with a claim for monetary damages against the estate that is adjudicated along with the claims of other creditors.

Originally, the Bankruptcy Code did not give much guidance regarding the treatment of IP licenses under Section 365. On one hand, the most significant legal event to occur under a licensing agreement – the grant of the license – occurs upon execution of the agreement. On the other hand, most licensing agreements include a range of ongoing commitments by the parties, including the payment of running royalties, confidentiality, indemnification and so forth. Given these factors, should an IP licensing agreement that was in place before a filing for bankruptcy generally be considered an executory contract or not? And if it is an executory contract, may a trustee in bankruptcy reject it long after the license has been granted?

The Fourth Circuit considered this question in the well-known case *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985). In that case, Richmond Metal Finishers (RMF) granted Lubrizol a nonexclusive license to utilize a metal coating process technology. The agreement required Lubrizol to pay periodic royalties to RMF. A year after the license was granted, RMF filed for bankruptcy under Chapter 11. As part of its plan to emerge from bankruptcy, RMF sought, pursuant to § 365(a), to characterize the agreement as executory and to reject it in order to facilitate a sale or licensing of the technology at a more favorable price. Lubrizol, not wishing to lose its rights under the agreement, argued that the agreement was largely performed and thus not executory.

The Fourth Circuit disagreed. First, it noted that under prevailing precedent, "a contract is executory if the obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete the performance would constitute a material breach excusing the performance of the other." Next, it outlined the as-yet unperformed duties of each of the parties:

> RMF owed the following duties to Lubrizol under the agreement: (1) to notify Lubrizol of any patent infringement suit and to defend in such suit; (2) to notify Lubrizol of any other use or licensing of the process, and to reduce royalty payments if a lower royalty rate agreement was reached with another licensee; and (3) to indemnify Lubrizol for losses arising out of any misrepresentation or breach of warranty by RMF. Lubrizol owed RMF reciprocal duties of accounting for and paying royalties for use of the process and of cancelling certain existing indebtedness.

Given these continuing obligations of both parties, the court held that the agreement was executory and permitted RMF to cancel it, leaving Lubrizol without the license that it had already paid a significant amount to secure.

The *Lubrizol* case led to a significant outcry in the technology sector, as firms quickly realized that the rights that they had under license were vulnerable to cancelation if their licensor entered bankruptcy proceedings. As a result, Congress convened hearings and three years later enacted the Intellectual Property Bankruptcy Act of 1988, which was codified as Section 365(n) of the Bankruptcy Code. As explained by one commentator:

> In enacting section 365(n), Congress recognized that technological development and innovation are advanced by encouraging solvent licensees to invest in start-up companies. Indeed, the economic reality is that intellectual property is often developed by undercapitalized companies relying on the financial support of solvent licensees to provide "venture capital" for development. To encourage investment in intellectual property and to protect the rights of licensees who contribute financing, research, development, manufacturing, or marketing skills, Congress limited the power of debtor-licensors to "reject" licenses as executory contracts.

> As the judiciary committees observed, it would be inequitable if a licensee who funded the development of the intellectual property, or who invested substantial monies in anticipation of using or marketing the technology, were denied the benefit of its bargain. It would also be unjust if the debtor or creditors' committee could unilaterally disclose jointly developed trade secrets, patents, or copyrightable information. Such disclosures would have a devastating effect on the licensee's business, possibly even causing its bankruptcy. The judiciary committees compared the licensee's predicament to that of a lessee of real property because in both instances the consequences of the debtor's breach is not compensable in monetary damages.[4]

Section 365(n), which is reproduced below, effectively eliminates the effect of a bankrupt licensor's rejection of an executory IP license by allowing the licensee to continue to enjoy the benefits of that license, so long as it continues to make all required payments (the subject of the *Prize Frize* case excerpted below).

BANKRUPTCY CODE SECTION 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 by such rejection if such rejection by the trustee amounts to such a breach as would entitle the licensee to treat such contract as terminated by virtue of its own terms, applicable nonbankruptcy law, or an agreement made by the licensee with another entity; or
   (B) to retain its rights (including a right to enforce any exclusivity provision of such contract, but excluding any other right under applicable nonbankruptcy law to specific performance of such contract) under such contract … to such intellectual property … as such rights existed immediately before the case commenced, for (i) the duration of such contract …
(2) If the licensee elects to retain its rights, as described in paragraph (1)(B) of this subsection, under such contract –
   (A) the trustee shall allow the licensee to exercise such rights;
   (B) the licensee shall make all royalty payments due under such contract for the duration of such contract …
(3) If the licensee elects to retain its rights, as described in paragraph (1)(B) of this subsection, then on the written request of the licensee the trustee shall –
   (A) to the extent provided in such contract … provide to the licensee any intellectual property … held by the trustee; and
   (B) not interfere with the rights of the licensee as provided in such contract … to such intellectual property … including any right to obtain such intellectual property … from another entity.

[4] Marjorie F. Chertok, *Structuring License Agreements with Companies in Financial Difficulty: Section 365(n) – Divining Rod or Obstacle Course?* 65 St. John's L. Rev. 1045 (1991).

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In Re Prize Frize, Inc.

32 F.3d 426 (9th Cir. 1994)

NOONAN, CIRCUIT JUDGE

This case, of first impression in any circuit, turns on whether license fees, paid by a licensee for the use of technology, patents, and proprietary rights, are "royalties" within the meaning of 11 U.S.C. § 365(n)(2)(B) and, as such, must continue to be paid after the licensor in bankruptcy has exercised its statutory right to reject the contract.

Facts

The debtor, Prize Frize, Inc., is the owner and licensor of all technology, patents, proprietary rights and related rights used in the manufacture and sale of a French fry vending machine. On March 6, 1991, the debtor entered into a License Agreement granting an exclusive license to utilize the proprietary rights and to manufacture, use and sell the vending machine. In consideration for the license to use the proprietary information and related rights, the licensee agreed to pay the debtor a $1,250,000 license fee – $300,000 to be paid within ten days of execution of the agreement with the balance due in $50,000 monthly payments. The licensee also agreed to pay royalty payments based on a percentage of franchise fees, of net marketing revenues and of any sales of the machines or certain related products. The license agreement also provided that if there was a failure of design and/or components of the machines to the extent that they were not fit for their intended use and were withdrawn from service, then the licensee's obligations would be suspended for a period of 180 days, during which time the debtor was entitled to cure any defect. Encino Business Management, Inc. (EBM) is the successor licensee under this license.

The debtor filed its Chapter 11 petition on March 12, 1991. In September of 1991, EBM, which had become the licensee, stopped making the $50,000 per month license fee payments and has made no payments since. EBM contends that there is a design defect in the machines which caused the machines to be withdrawn from service and which allowed the suspension of its obligation to pay the debtor.

The debtor subsequently filed a motion to reject the license agreement with EBM and to compel EBM to elect whether it wished to retain its rights under section 365(n)(1). EBM did not file a written response to the motion. At the hearing, EBM's counsel indicated that he did not oppose rejection. He disputed, however, that EBM should be required to immediately pay $350,000 in past due license fee payments, contending that the obligation to make such payments was suspended because of the purported design defect.

The bankruptcy court entered an order indicating that the debtor might reject the agreement, that EBM might elect whether to retain its rights under the agreement pursuant to section 365(n)(1) and that if EBM elected to retain its rights under the agreement it must do the following: (1) make all license fee payments presently due in the amount of $350,000 within seven days of its election; (2) pay the $400,000 balance of the license fee in monthly installments of $50,000; and (3) waive any and all rights of setoff with respect to the contract and applicable non-bankruptcy law and any claim under section 503(b) arising from performance under the agreement. The court's order also stated that assuming, arguendo, that EBM's payment obligations were properly suspended, the 180-day suspension period had ended and the September to March monthly payments were now due.

EBM appealed.

Analysis

Section 365 of the Bankruptcy Code is an intricate statutory scheme governing the treatment by the trustee in bankruptcy or the debtor-in-possession of the executory contracts of the debtor. There is no dispute that the license agreement between EBM and the debtor was executory, i.e. there were obligations on both sides which to some extent were unperformed. Consequently, the debtor had the right to reject the contract. However, section 365(n)(1) qualifies this right when the debtor is "a licensor of a right to intellectual property." There is no dispute that the debtor is such a licensor. Consequently, EBM as "the licensee under such contract" could make an election. § 365(n)(1). EBM could either treat the contract as terminated as provided by (n)(1)(A), or EBM could retain its rights to the intellectual property for the duration of the contract and any period for which the contract might be extended by the licensee as of right under applicable nonbankruptcy law.

EBM elected to retain its rights. It was then obligated to "make all royalty payments due under such contract." By the terms of the statute EBM was also "deemed to waive any right of setoff it may have with respect to such contract under this title or applicable nonbankruptcy law."

Section 365(n) has struck a fair balance between the interests of the bankrupt and the interests 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 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. [The] legislative history buttresses this commonsense interpretation of "royalties" in the statute.

EBM's principal argument is that the licensing agreement itself makes a distinction between what the agreement calls "license fees" and what the agreement calls "royalty payments." The "royalty payments" in the agreement are percentages payable on the retail sales price of each machine sold by EBM; the "license fees" in the agreement are the sums here in dispute which were to be paid for the license to manufacture and sell the vending machine. EBM's argument is not frivolous. Nonetheless the parties by their choice of names cannot alter the underlying reality nor change the balance that the Bankruptcy Code has struck. Despite the nomenclature used in the agreement, the license fees to be paid by EBM are royalties in the sense of section 365(n). Section 365(n) speaks repeatedly of "licensor" and "licensee" with the clear implication that payments by licensee to licensor for the use of intellectual property are, indifferently, "licensing fees" or "royalties," and, as royalties, must be paid by the licensee who elects to keep its license after the licensor's bankruptcy. The same indifference to nomenclature in referring to a licensee's lump sum or percentage-of-sales payments as royalties is apparent in patent cases.

EBM's fallback position on appeal is that the debtor has been freed by its rejection of the contract from the obligations assumed by the debtor under Article V ("Representations, Warranties and Covenants by PFI") of the agreement. These obligations included the debtor's agreement to hold EBM harmless from any claim arising out of events preceding the agreement, to defend any infringement suit relating to technology or design included in the machine, and to prosecute at its own expense any infringers of the rights granted by the agreement. The debtor also represented that the design of the Stand-Alone Machine was free from material defects. These 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. Neither the bankruptcy court nor the BAP addressed this possibility. They did not because EBM did not present this question to them. It is consequently too late to raise it here. EBM still has its unsecured claim for breach of the entire license agreement that § 365(g) accords it. As its appeal was non-frivolous, no attorney's fees are awarded.

As what the licensing agreement denominates "license fees" must be regarded as "royalty payments" for purposes of § 365(n)(1)(B), the judgment [is] AFFIRMED.

Notes and Questions

1. *Executory contracts: copyright*. The issues discussed above are not unique to patent licenses. In *Otto Preminger Films, Ltd. v. Quintex Entertainment, Ltd.*, 950 F.2d 1492 (9th Cir. 1991), the Ninth Circuit held that a contract relating to the colorization of several motion pictures was executory. Among other things, the contract required the licensor to: (1) refrain from selling the rights to subdistribute the movies to third parties; (2) indemnify and defend the licensee; and (3) exercise creative control over the colorization and marketing of the pictures. In addition, the licensee remained contractually obligated to give accountings and pay royalties for future sales of the pictures.

   Likewise, in *In re Select-A-Seat Corp.*, 625 F.2d 290 (9th Cir. 1980), the court held that an exclusive software license was executory because the licensee remained obligated to pay the licensor a portion of the licensee's annual net return from use of the software, while the licensor remained obligated not to sell its software packages to other parties.

   All things considered, do these agreements sound executory to you? If so, what obligations would need to be eliminated to make these agreements non-executory? Realistically, are there any IP licensing agreements that are not executory by these standards?
2. *The* Lubrizol *effect*. As noted above, Congress enacted Section 365(n) as a direct response to the *Lubrizol* decision. What was so wrong with *Lubrizol*? And if Section 365(a) allows the rejection of other executory contracts, why should IP licenses be treated differently?[5]
3. *The effect of 365(n)*. Do you agree with the court in *Prize Frize* that "Section 365(n) has struck a fair balance between the interests of the bankrupt and the interests of a licensee of the bankrupt's intellectual property"?
4. *Trademark licenses*. Section 101(35A) of the Bankruptcy Code defines "intellectual property" as including trade secrets, patented inventions, plant varieties, copyrighted works and semiconductor mask works. Notably absent from this list are trademarks. One reason for this omission, it has been argued, is that a trademark licensor is required to exercise quality control over the goods and services sold under its mark (see Section 15.3). If a trademark licensor is in bankruptcy, and is required to allow its licensees to retain their right to use its marks, then the licensor will necessarily be required to exert effort to police the use of those marks – an effort that may not serve to maximize the value of the bankruptcy estate.

   Courts were divided over the ability of a trademark licensor to reject trademark licenses in bankruptcy. The confusion was finally resolved by the Supreme Court in *Mission Product*

[5] Note that there is a similar exclusion in the Bankruptcy Code for real estate leases. 11 U.S.C. 365(h)(1) prohibits a debtor landlord from evicting a tenant who does not wish to vacate the premises.

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Holdings v. Tempnology, LLC, 139 S. Ct. 1652, 1662 (2019). There, the Court looked not to Section 365(n), which admittedly does not include trademarks within its ambit, but to the effect of breach on licenses outside of the bankruptcy context. That is, Section 365(g) of the Bankruptcy Code provides that if a trustee in bankruptcy rejects a debtor's obligations under an executory contract, that rejection constitutes a breach of the agreement. But outside the bankruptcy context, a breach of contract by a licensor of IP does not automatically terminate the licensee's rights. The licensee's rights cease only if the licensee elects to terminate the contract for the licensor's breach. Upon a licensor's breach, the licensee gains a remedy in damages against the licensor, and may also continue to enjoy its rights under the agreement. Why, then, the Court asks, should a debtor licensor's breach in bankruptcy change this situation? "A debtor's property does not shrink by happenstance of bankruptcy, but it does not expand, either." Accordingly, a bankrupt trademark licensor may reject and stop performing its obligations under an executory license, but it cannot "rescind the license already conveyed." So, the Court concludes, "the licensee can continue to do whatever the license authorizes." Do you agree with the Court's reasoning in *Mission Product*? Why would the Court protect trademark licensees contrary to the Congressional intent made evident by leaving trademarks out of the IP exclusion under Section 365(n)? Should Congress again correct the courts, as it did after the decision in *Lubrizol*?

5. *Contractual bankruptcy clauses*. Never wishing to forego an opportunity to include new clauses in license agreements, transactional attorneys have developed contractual language directed to Section 365(n) which often takes the following form:

> *Rights in Bankruptcy*. Licensor acknowledges and agrees that the licenses and rights granted in this Section by Licensor to Licensee with respect to the Licensed Rights are licenses and rights to "intellectual property" within the definition of Section 101(35A) of the Code. The parties hereto further agree that, in the event of the commencement of a bankruptcy proceeding by or against Licensor under the Code, Licensee shall be entitled, at its option, to retain all its rights under this Agreement, including without limitation [list], pursuant to Code Section 365(n). Rejection pursuant to Section 365 of the Code constitutes a material breach of the contract and entitles the aggrieved party to terminate upon written notice.

Is this language necessary? What advantages may lie in including it in an agreement?

21.4 ASSIGNMENT BY BANKRUPT LICENSEE

In a bankruptcy proceeding, the "debtor in possession" (DIP) is technically considered a separate legal entity from the debtor company itself. Accordingly, when the DIP takes possession of the assets of the debtor (the bankruptcy estate), those assets are assigned from the debtor to the DIP. This transfer is described in Section 541(c) of the Bankruptcy Code, which provides that a contract of the debtor becomes property of the bankruptcy estate "notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law … that restricts or conditions transfer of such interest by the debtor."

However, there is an exception for executory contracts. Section 365 of the Code provides:

> (c) The trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if –
>
> (1) (A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor

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or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and

(B) such party does not consent to such assumption or assignment

Thus, under Section 365(c)(1)(A), if applicable law does not permit the assignment of an executory contract, it may not be assigned by the trustee.

How does this rule apply to IP licenses? As discussed in Section 13.3, a licensee's interest in a nonexclusive copyright or patent license may not be transferred without the consent of the licensor. In *Everex Systems, Inc. v. Cadtrax Corp.*, 89 F.3d 673 (9th Cir. 1996), the Ninth Circuit confirmed that the rule of nonassignability applies in the bankruptcy context. In *Everex*, the court held that a nonexclusive patent license could not be assumed or assigned even though it was found to be an executory contract for bankruptcy purposes because, under federal law, a nonexclusive license is only assignable with the consent of the licensor.

But in *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1997), the First Circuit refused to follow the Ninth Circuit's lead. It held that when a debtor sought to assign a nonexclusive patent license to the DIP, the assignment did not run afoul of the rule against assignability, as the only difference between the pre-petition debtor and the post-petition DIP was pro forma:

> Where the particular transaction envisions that the debtor-in-possession would assume and continue to perform under an executory contract, the bankruptcy court cannot simply presume as a matter of law that the debtor-in-possession is a legal entity materially distinct from the pre-petition debtor with whom the nondebtor party … contracted. Rather, sensitive to the rights of the nondebtor party … the bankruptcy court must focus on the performance actually to be rendered by the debtor-in-possession with a view to ensuring that the nondebtor party … will receive the full benefit of [its] bargain.

Notes and Questions

1. *Assignment to one's self*. Considering the decisions in *Everex* and *Institut Pasteur*, what do you think of applying the prohibition on assignment to an assignment of an agreement from a pre-petition debtor to a post-petition DIP? Which court's reasoning seems more practical?
2. *Overriding prohibitions on assignment*. Section 365(f)(1) of the Bankruptcy Code allows a trustee in bankruptcy (or a debtor in possession) to assign many of the debtor's executory contracts even if the contracts themselves forbid assignment. What is the rationale for this rule? Why should a trustee be permitted to override the parties' agreed prohibition on assignment of an agreement?

21.5 *IPSO FACTO* CLAUSES

Section 365(e)(1) of the Bankruptcy Code provides that:

> Notwithstanding a provision in an executory contract … or in applicable law, 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 or lease *that is conditioned on* -
>
> (A) the insolvency or financial condition of the debtor at any time before the closing of the case;

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(B) the commencement of a case under this title; or
(C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.

In effect, this provision prohibits the parties to an executory contract, such as an IP license, from agreeing that the contract will terminate upon the initiation of a bankruptcy proceeding or other event under the Code (there are some exceptions to this rule, for example, for personal service contracts). Thus, under US law, *ipso facto* (by the very fact or act) bankruptcy termination clauses are facially invalid. This result was confirmed in *Computer Communications, Inc. v. Codex Corp.*, 824 F.2d 725 (9th Cir. 1987), in which the parties entered into a technology development and purchase agreement that stipulated that certain events, including bankruptcy, would constitute default under the agreement. Two days after the parties executed the agreement, Computer Communications, Inc. (CCI) filed a petition for reorganization under Chapter 11. Shortly thereafter, Codex notified CCI that it was terminating the agreement under the bankruptcy clause. The district court held, however, that § 365(e)(1) prevented Codex from unilaterally terminating the contract. The Ninth Circuit affirmed, though on slightly different grounds.

Despite the relatively clear rule under § 365(e)(1), it is common to see *ipso facto* clauses in the termination sections of agreements, particularly IP licensing agreements. An example of such a clause follows.

EXAMPLE: TERMINATION FOR INSOLVENCY CLAUSE

Without prejudice to either party's other rights and remedies, either party shall have the right to terminate this Agreement upon written notice to the other upon:

(a) the entry of an order for relief against the other party under Title 7 or 11 of the United States Bankruptcy Code ("Code");
(b) the commencement of an involuntary proceeding under the Code against the other party, if not dismissed within 30 days after such commencement;
(c) the making by the other party of a general assignment for the benefit of creditors;
(d) the appointment of or taking possession by a receiver, liquidator, assignee, custodian, trustee, or other similar official of some or all of the business or property of the other party;
(e) the institution by or against the other party of any bankruptcy, reorganization, arrangement, insolvency or similar proceedings under the laws of any jurisdiction;
(f) the other party becoming insolvent or generally failing to pay its debts as they become due; or
(g) any action or omission on the part of or against the other party that would lead to the dissolution or winding up of substantially all of its business.

In order to enable the parties to exercise their rights under this Section __, each party hereby agrees to provide the other party with written notice promptly upon the occurrence of any of the events listed in Subsections (a) to (g) above.

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Notes and Questions

1. *Illegal or customary?* Given that *ipso facto* bankruptcy termination clauses are invalid under US law, why are they so common in IP licensing agreements? Bankruptcy experts offer several explanations for this seeming discrepancy:

   - These clauses were permissible prior to the enactment of the 1979 Bankruptcy Act, and attorneys may simply include them in agreements due to force of habit.
   - Such clauses may be valid outside of the United States and thus remain useful in international agreements.
   - The US law prohibiting *ipso facto* clauses could change to recognize the validity of such clauses, so it is safest to retain the clauses against such a day.
   - The Code only prohibits termination that is triggered upon the filing or existence of a "case" under the Bankruptcy Code. Less formal indicia of a debtor's insolvency may not run afoul of the *ipso facto* rule.

   Which of these rationales is most convincing to you? Would you include an ipso facto bankruptcy termination clause in a contract you were drafting? Why or why not?

Problem 21.3

Your client, Acme Sports, licenses its trademarks, trade secrets and copyrights to third parties around the world in connection with the marketing and manufacturing of athletic wear. Acme Sports has entered into hundreds of these licensing agreements, all of which must be renewed every five years. Acme Sports would like to have the option to terminate a licensing agreement if the licensee files for bankruptcy. As the next round of renewals approaches, what would you, as Acme Sports' lawyer, recommend? Would you recommend a provision in the contract specifying that Acme Sports may terminate the contract if the licensee becomes insolvent? What about a provision that terminates the contract if a party files for bankruptcy?

21.6 BANKRUPTCY AND ESCROW

A licensee of technology – particularly software – will often depend on the licensor to maintain, update and correct errors in the licensed technology throughout the licensee's period of use. But what happens if the licensor becomes unable to perform those maintenance, updating and error correction services, either through insolvency, bankruptcy or otherwise? If the technology is complex and its inner workings are described in designs, documentation or computer "source code" (see Section 18.1) that are not provided to the licensee as part of its license, then the licensee has little chance of assuming these critical functions once the licensor is out of the picture. As a result, a very expensive technology system may become useless to the licensee that has paid for it.

To guard against this scenario, some licensees require the licensor to place software source code and other design information in "escrow" against the day when the licensor is no longer able to provide critical support and maintenance services.

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Technology Licensing: A Practitioner's Guide

Heather J. Meeker, 4th ed., 2018 at 90–93

An independent trustee—usually a firm in the business of doing technology escrows—is appointed as the escrow agent for licensor and licensee. The parties enter into a three-way agreement that is essentially a trust arrangement. The licensor delivers a copy of the source code to the escrow agent, and is usually required to deliver a source code update whenever it delivers a corresponding object code update to the licensee under the agreement. Upon occurrence of a triggering event, the escrow agent delivers the escrowed source code to the licensee. The escrow agreement, or the original license agreement, should include a license grant that is effective upon delivery by the escrow agent.

Most of the provisions of escrow agreements are not heavily negotiated. Sometimes the parties negotiate who will pay the fees. Typically the licensee pays these fees, if only because a licensor nearing bankruptcy may not place escrow fees at the top of its financial priorities, and the escrow agent may not be willing to release an escrow deposit with fees due in arrears. Parties also negotiate the dispute resolution mechanism if there is a disagreement over whether a triggering event has occurred. Licensees usually want fast arbitration, because obtaining the source code a year after a bug has appeared and maintenance has ended does not do much to address the licensee's quiet enjoyment issue.

The heavily negotiated provisions are the trigger events. Some of them relate to bankruptcy, and some do not:

- Filing of Chapter 7 (also cessation of business in the ordinary course, liquidation without filing of a bankruptcy provision). This trigger is ubiquitous and seldom controversial.
- Filing of Chapter 11. The licensor may argue that, for the reasons discussed above, Chapter 11 will not be likely to interrupt maintenance services.
- Breach of the Licensor's Maintenance Obligations. Licensors are wary of agreeing to this, particularly if the maintenance obligations in the agreement are vague or stringent.
- Change of Control of Licensor. This is a "poison pill" for an acquisition of the licensor, and the licensor usually tries to negotiate against it.

When drafting and negotiating licenses that involve escrows, the parties may attach an executed escrow agreement as an exhibit to the document. However, the parties often do not have time to set up the escrow or have the escrow agent sign the document before executing the underlying license. In those cases, you might use the following provision, which is drafted to favor the licensor:

> *Escrow*. No later than 30 days after the Effective Date, the parties shall enter into a source code escrow agreement with [an escrow agent reasonably acceptable to both parties] [name of escrow agent], pursuant to which Licensor shall make Licensee the beneficiary of source code and source materials embodying the Software that are deposited by Licensor with such agent. Licensor hereby grants to Licensee the right to use, reproduce, and prepare derivative works of the source code and source materials for the Software and derivative works thereof; provided that Licensee may exercise such rights only in the event of a release of such materials pursuant to such source code escrow agreement, and only for the purpose of maintaining and correcting errors in the Software. The parties agree that such release will take place only if and when Licensor ceases business in the ordinary course. Licensee shall pay all fees associated with such escrow account.

Note the present language of grant in the license: "Licensor hereby grants to Licensee … provided that Licensee may exercise such rights only in the event of a release of such materials pursuant to such source code escrow agreement." This is the proper way to draft this provision, as opposed to: "Licensor shall grant to Licensee … upon a release of such materials pursuant to such source code escrow agreement." This is an issue for the licensee's counsel to spot. The obligation to grant a license may be more difficult to enforce, because it could require a court to mandate the granting of a license, and courts are reluctant to grant mandatory injunctions.

The Flow-Down Problem

There is a lurking issue in software escrows that is rarely considered by licensees. Few software developers today develop their entire product from scratch. Suppose a licensor (DevCo) provides an escrow for a licensee (DistyCo) that intends to redistribute the software. DistyCo's customers also want an escrow of source code in the event DistyCo goes out of business. But part of the software provided by DistyCo to its customers belongs to licensors like DevCo. DistyCo's escrow for its customers will not work, because DistyCo probably cannot grant its customers any rights in Devco's source code. If it did, then in the type of escrow provision described above, a failure of the business of DistyCo would trigger release of the source code of DevCo. DevCo is likely to take a dim view of this.

If this problem arises, one way to solve it is as follows:

> If Licensee is in material breach of its support obligations for the Software to any customer of Licensee to whom Licensee has licensed the Software under this Agreement, Licensor shall, at its sole option and discretion, either (a) assume Licensee's rights and obligations for support of the Software with respect to such customer, including without limitation making such customer the beneficiary of and granting such customer the rights in Software source code and source materials of this Section ___, or (b) instruct the escrow agent to release the source code and source materials to such customer, and grant to such customer the right to use, reproduce, prepare derivative works of, perform, display and transmit the source code and source materials for the Software and derivative works thereof.

This will address the customer's need for continuing access to technology, but not force DevCo to lose control of its source code.

Escrows in the 21st Century

Escrows have always had their issues. They are often not properly updated by the Licensor, so the binaries the Licensee is using does not correspond with the software in escrow. Source code is often poorly documented, and the Licensee often does not have the human resources to fix problems, even if it has access to source code. Software runs in a larger computing environment, and it is very difficult to capture that environment in an escrow.

Software escrows used to be ubiquitous in software licensing deals, but today, they are much rarer. One reason is that computing has tended to become vertically dis-integrated, so it may be easier to find substitutes for software whose vendor is no longer available. Another is that many technologists are skeptical about the value of escrows, for the reasons given above. Another reason is the rise of cloud computing or SaaS—it is nearly impossible to properly capture a SaaS product in an escrow. So, today, many licensees dispense with the escrow terms of license agreements.

The good news is that open source software has changed how escrows are done. It might be counterintuitive, but open source is great to put in escrow—mainly so that a licensee

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can capture the exact computing environment for the application it is licensing, with no worries about the right to include these third party components. Open source software has also changed the expectations of licensees; engineers now expect to get source code and not just binaries from vendors, so the function of escrows has changed.

Twenty years ago, asking for an escrow was an expected part of a software license. Today, if you demand an escrow on behalf of a licensee, the licensor may challenge you about why it is necessary, so be prepared to discuss the practicalities of software escrows.

FIGURE 21.1 Some technology escrow providers.

Notes and Questions

1. *Escrowed materials*. The excerpt from Meeker above focuses on software source code. Do you think that the same considerations would apply to an escrow of other technical information, such as manufacturing diagrams for a mechanical part, bills of materials, ingredients lists and the like?
2. *Escrow in practice*. Escrow agents are risk-averse, and escrow agreements typically go out of their way to protect the escrow agent from any potential liability. Thus, if a triggering event occurs and the licensee makes a request to obtain source code or other materials from escrow, any objection on the part of the licensor will usually be sufficient to prevent the release until a court has ordered the escrow agent to comply. Why do escrow agents include these provisions in their agreements? Does waiting for a court order frustrate the entire purpose of the escrow?
3. *Two-party versus three-party escrow*. Technology escrow agreements often come in two flavors: two-party and three-party. Three-party agreements are among the licensor, licensee and escrow agent and specify the conditions under which the agent will release the escrowed materials to the licensee. Two-party agreements only involve the licensor and the agent. These agreements provide for the escrow of materials and payment of the agent's fees. In addition, the licensor provides the agent with a list – updated periodically – of licensees who are permitted to make claims against the escrow account. Which of these contractual approaches would you prefer if you were the licensee? The licensor?
4. *Escrow and* OSS. Meeker writes that open source software is "great" to escrow. Why is this? If source code for this software is already available, why would the parties need to spend money on an escrow?

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