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## INTELLECTUAL PROPERTY AND TRANSACTIONAL LAW CLINIC

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## BANKRUPTCY AND INTELLECTUAL PROPERTY

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### INTRODUCTORY OVERVIEW

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Bankruptcy cases can dramatically alter a debtor's assets and contractual obligations. The debtor might have to surrender property, money, and other holdings to creditors. The bankruptcy court might also remove or discharge a debtor's contractual responsibilities, allowing him to breach otherwise valid agreements. These changes work to possibly give the debtor a fresh start in the face of unmanageable debt as well as help creditors minimize their losses. However, third parties might be unduly injured by the bankruptcy case of a debtor with whom they had entered into an agreement. In the case of intellectual property ("IP") licenses, non-debtor licensors may have only intended to provide licenses to the debtor. If that debtor licensee assigns the license to a third party, the licensor could be obliged to maintain an unwanted license. Also, non-debtor licensees contracting to use a debtor's IP might base their entire business around the use of a debtor's property, such as a software product. The loss of such a license might cripple such a licensee. Therefore, the Bankruptcy Code (the "Code") Section 365 directly addresses intellectual property licenses, limiting the actions of debtors and minimizing the ill effects of bankruptcy on licensing parties.

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### "INTELLECTUAL PROPERTY" IN BANKRUPTCY

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In general, intellectual property consists of those intangible assets that are the creation of the mind. Businesses usually consider inventions, expressions, confidential plans, and branding identifiers as IP. However, the Code explicitly defines "intellectual property" as it pertains to the federal laws regarding a bankruptcy case and a debtor's assets. In Section 101(35)(A), the Code states that "intellectual property" includes trade secrets, patents or patent applications, and copyright works. Notable omissions to this definition are trademarks and trademark licenses. Thus, bankruptcy provisions that address IP licenses impact only those licenses where the debtor is a party

to an agreement regarding patents, trade secrets, and copyrights. Bankruptcy provision references to IP do not affect any trademark license or rights.

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### IP LICENSES AS EXECUTORY CONTRACTS

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Section 365 of the Code describes a debtor's ability to adjust preexisting executory contracts. An executory contract is an agreement that has significant obligations left to be completed or performed by both contracting parties. IP licenses typically qualify as executory contracts. Licensors owning an IP asset, such as a software copyright, can give a licensee the rights to use that software and receive any service updates it might need for business usage. Licensees usually develop around the licensed property and become reliant upon its availability to them.

Even after the debtor gains relief from responsibilities because of the automatic stay of bankruptcy, he must still decide what to do with his contractual obligations. The Code gives the debtor three basic options for proceeding with such contracts: assume, reject, or assign. Assumption of a contract means that the debtor will continue performing as stipulated by the original contract and cure any breaches he has caused. Assignment allows the debtor to transfer/sell some contracts to a third party, who will then maintain the agreement with the other original contracting party. Rejection is a debtor's ability to breach the agreement, and thus create bankruptcy claims for the other contracting party. Usually, rejection is a harsh conclusion for the other contracting party, as they are deprived of the benefit of the agreement and left with only an unsecured claim that is never paid by the debtor's estate. Acknowledging the special value of IP licenses, the Code creates exceptions to these basic bankruptcy debtor powers.

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### DEBTOR AS LICENSEE

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When a bankruptcy debtor is an IP licensee, assumption or assignment of that license can provide relief to that debtor. Generally, a debtor can assume a license if he cures any defaults and gives adequate assurance of future performance of the license. However, the Code may limit the debtor licensee's ability to act through Section 365(c), which states that a debtor licensee may not assign a license to another third party if the applicable law, such as local state law or federal patent law, indicates that the other contracting party does not have to allow the assumption or assignment and does not consent to the assumption or assignment. Here, a licensor could prevent the debtor licensee from selling the license to another party and receiving any resulting proceeds into the bankruptcy estate. This would presumably protect the licensor from performing the contract with an unintended party.

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### DEBTOR AS LICENSOR

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A debtor licensor may prefer to reject an IP license in order to limit his future responsibilities or costly contractual obligations to the licensee. Section 365(n) of the Code removes this debtor's freedom to completely reject a license. As licensees may have become overly dependent upon the IP assets bargained for in the license, the Code provides the non-debtor licensee with options when the debtor rejects an IP license. The licensee first has the option to simply allow the rejection and treat the license as terminated, thus allowing the licensee to sue for breach under non-bankruptcy law. Alternatively, Section 365(n) allows the non-debtor licensee to

elect to continue to use the licensed IP. If the non-debtor selects this option, the licensee retains his rights that existed at the time of the debtor's bankruptcy case commencement, but must continue to pay license royalties to the debtor. Additionally, the licensee waives any right to set-off, or the right to deduct the value of services or money owed to it from its future payments to the licensor. In this situation, the debtor licensor would not likely provide any new services, such as software updates, but would be obligated to maintain the license under its initial contractual terms. Section 365(n) protects the licensee, allowing him to continue his use of the IP regardless of the licensor's bankruptcy.

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SEE ALSO

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- Epstein, David, Markell, Bruce, Nickles, Steve, and Perris, Elizabeth, *BANKRUPTCY, MATERIALS AND CASES* (3<sup>rd</sup> Ed. 2010).