GONE BROKE?

IP ASSETS OF CLIENTS OR FIRMS GOING IN AND OUT OF BANKRUPTCY

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Across the Border: IP Entanglements in Chapter 15 Bankruptcies, by Henry Kevane

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I. Key Bankruptcy Concepts.

1. Cases. Most bankruptcy cases are filed under Chapter 11 (reorganization). The "debtor in possession" concept is the norm (meaning that pre-existing management remains in control of the company). Trustees are appointed in Chapter 7 cases (liquidation) and may, for cause such as mismanagement or fraud, be appointed in Chapter 11 cases. To commence a case, a debtor must reside (in the case of individuals), or have a domicile, place of business or property in the U.S. (in the case of organizations). The commencement of a bankruptcy case creates an "estate." The estate is generally comprised of all of the debtor's pre-petition property, wherever located.[1]

2. Claims. An administrative expense is a claim that arises after the commencement of the case and that confers a benefit upon, or preserves, the estate. Administrative expenses are typically paid when due (and must otherwise be paid in full as a condition to confirming a plan). Pre-petition claims are generally classified as "secured," "priority," or "general unsecured." Priority claims, such as pre-petition wages, are paid ahead of general unsecured claims. Equity securities, which include all types of shares, securities and ownership interests, are junior to general unsecured claims. The "absolute priority rule," codified in § 1129, generally requires that a class of senior claims must be paid in full before any value may be received or retained by a junior class.

II. Chapter 15 Bankruptcy Cases.

1. Purpose. Chapter 15 of the Bankruptcy Code, enacted in 2005 (and applicable to cases filed on or after October 17, 2005), is the vehicle under which a foreign representative in a foreign insolvency proceeding enlists the aid of the United States Bankruptcy Court in order to protect and administer the property of a foreign debtor.[2] Chapter 15 presumes a foreign debtor – *i.e.*, an entity organized abroad. Chapter 15 is intended to be flexibly interpreted to achieve cooperation among domestic and foreign insolvency participants. It applies in three general contexts: (1) where parties to a foreign proceeding seek assistance in the U.S., (2) where parties

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[1] The Bankruptcy Court (by reference from the district court), has "exclusive jurisdiction" of all the property, wherever located, of the debtor and of property of the estate. 28 U.S.C. § 1334(e).

[2] A complete copy of Chapter 15 of the Bankruptcy Code is attached to these materials. All section references are to the Bankruptcy Code, title 11 of the United States Code.

to a domestic case seek assistance in a foreign country, and (3) where a foreign proceeding and a domestic case for the same debtor are pending concurrently. § 1501(b). If the foreign proceeding is formally "recognized" by the Bankruptcy Court, the automatic stay otherwise applicable to a domestic case will apply to the foreign debtor and its tangible and intangible property located within the territorial jurisdiction of the U.S.[3] In addition, upon recognition of a foreign proceeding, the foreign representative may (i) seek "additional assistance" from both the Bankruptcy Court and other courts in the U.S. (and has the capacity to sue and be sued in such courts), and (ii) if the foreign debtor has assets in the U.S., commence a plenary domestic case.

2. Override. All of Chapter 15 is qualified by a public policy escape hatch – the Bankruptcy Court may refuse "to take an action governed by his chapter if the action would be manifestly contrary to the public policy of the United States." § 1506. The few cases that have considered this public policy override have concluded that it is a narrow exception intended to be applied only in exceptional circumstances concerning matters of "fundamental importance" (*i.e.*, constitutional guarantees). As discussed below in connection with the *Qimonda* case, this public policy override is being invoked to protect domestic patent licensees from the otherwise harsh effects of German insolvency law regarding the treatment of executory contracts.

3. Eligibility. Chapter 15 does not apply to certain entities listed in § 1501(c).[4] Specifically, Chapter 15 is inapplicable to those entities not otherwise eligible to be a debtor under § 109(b) – mainly foreign banks with U.S. branches. Foreign insurance companies, on the other hand, although ineligible to be debtors under other chapters of the Bankruptcy Code, are eligible for recognition under Chapter 15.

4. Process. A foreign representative for a debtor that is the subject of a foreign proceeding can commence an ancillary case under Chapter 15 in the U.S. by filing a petition for recognition.[5] §§ 1504, 1509, 1515. A foreign proceeding might be a **main** proceeding (*i.e.*,

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3 Under Chapter 15, the reach of the "territorial jurisdiction of the United States" expressly includes the intangible property of a foreign debtor that is "deemed under applicable nonbankruptcy law to be located" within such territory, including any property subject to attachment or garnishment in a federal or state court in the U.S. § 1502(8). Under the UCC, patents, trademarks, copyrights and software are each generally considered a "general intangible" to which a security interest may attach and be perfected (although in some cases not merely by filing a financing statement). The "territorial jurisdiction" qualification is intended to replicate the scope of an "estate" otherwise created under the Bankruptcy Code, which concept does not apply to ancillary cases.

4 There is some ambiguity in the use of the term "debtor" under Chapter 15. "Debtor" is defined in § 101(13) as a person concerning which a case under this title has been commenced. The Bankruptcy Code (*i.e.*, title 11), includes cases under Chapters 7 (liquidation), 9 (municipalities) 11 (reorganizations and railroads), 12 (family farmers), 13 (individuals with regular income) and 15 (cross-border). Section 109 further states that only a person that has a domicile, place of business or property in the U.S. may be a debtor under title 11 (again, including all chapters). Chapter 15, on the other hand, has a separate definition of a debtor – "an entity that is the subject of a foreign proceeding." Chapter 15 thus permits the commencement of an ancillary case (which is a case under title 11) even if the foreign debtor has no domicile, place of business or property in the U.S.

5 Where can a Chapter 15 ancillary case be commenced? An ancillary case may be commenced in any district (a) where the foreign debtor has a principal place of business or assets in the U.S., (b) if none, where an action against the debtor is pending in a Federal or State court, or (c) if none, where consistent with the interests of justice and the convenience of the parties. 28 U.S.C. § 1410.

located in a country where the debtor has the center of its main interests (COMI)),[6] or a **nonmain** proceeding (*i.e*., located in a country where the debtor has an "establishment, that is, "any place of operations where the debtor carries out a non-transitory economic activity"). Once a petition for recognition is filed, and an ancillary case commenced, the Bankruptcy Court can order provisional relief if urgently needed pending a decision on the petition (such as staying execution against the debtor's assets). § 1519. This provisional relief expires upon entry of the recognition order, unless expressly extended in the recognition order.

5. Recognition Order. The entry of a recognition order by the Bankruptcy Court under § 1517 is the predicate for the various rights and remedies available to a foreign representative under Chapter 15. Chapter 15 vests the Bankruptcy Court as the "gatekeeper" for a foreign representative's access to the Bankruptcy Court and other domestic courts. Indeed, if the Bankruptcy Court denies recognition (either because it refuses to act on the petition if contrary to the public policy of the U.S., or because the petition is otherwise flawed), the Bankruptcy Code may enter any order necessary to prevent the foreign representative from obtaining comity or cooperation from courts in the U.S. § 1509(d).

6. Effects of Recognition. Once a foreign **main** proceeding has been recognized, pursuant to § 1520 certain provisions of the Bankruptcy Code (such as the automatic stay) will automatically apply to the debtor and its property located within the territorial jurisdiction of the U.S. If, on the other hand, the foreign proceeding is a **nonmain** proceeding, the foreign representative must request specific "appropriate relief " under § 1521. The foreign representative in a **main** proceeding can likewise request further "appropriate relief" from the Bankruptcy Court under § 1521 (such as the selected application of other provisions of the Bankruptcy Code) to bolster the automatic relief granted under § 1520. Moreover, upon recognition, a foreign representative can also (i) pursuant to § 1507, ask for "additional assistance" under the Bankruptcy Code or any other laws of the U.S. under, and (iii) pursuant to § 1511, commence a domestic bankruptcy case if the foreign debtor also has assets in the U.S. under.

7. Types of Additional Relief. It is not uncommon for the recognition order to be festooned with further "appropriate relief," particularly since § 1521(a)(7) permits the court to grant "any additional relief that may be available to a trustee." Notably, however, the Bankruptcy Court may not extend the reach of §§ 547, 548 and 550 (avoidance and recovery of preferential and fraudulent transfers), among other sections, to the ancillary case. Accordingly, a foreign representative does not have authority in an ancillary case to commence garden variety avoidance actions (and must commence a plenary case in order to invoke those rights). On the other hand, turnover proceedings under §§ 542 and 543 are not excluded from the further relief that may made applicable to an ancillary case under § 1521. Any further relief that is granted under §1521 may also be modified or terminated upon request of the foreign representative or an entity affected by such relief. § 1522(c). The *Qimonda* case, discussed below, involved a

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[6] Chapter 15 does not define the COMI, although it is presumed to be the debtor's registered office under § 1561(c). The COMI determination is often a matter of some dispute, and the recent cases of certain Cayman Islands-registered hedge funds (*e.g*., Sphinx Ltd., Bear Stearns High-Grade Structured Credit Strategies Master Fund, Basis Yield Alpha Fund), illustrate some of the factors considered by the courts.

recognition order that made § 365 initially applicable to the debtor, followed by a request by the foreign representative under § 1522(c) to modify that relief.

8. Plenary Domestic Case. As noted, upon recognition, a foreign representative is also authorized to commence a parallel domestic bankruptcy case if the foreign debtor has assets in the U.S. *See* §§ 1511, 1520(c) and 1528.[7] The commencement of a plenary case under Chapter 11 or 7 would entitle the foreign representative to further remedies not otherwise available in an ancillary case, but would also require the invocation of certain coordination and cooperation provisions under § 1529. Why would a foreign representative whose foreign proceeding has been recognized (thus invoking the stay of acts against the foreign debtor and any of its assets in the U.S.), also commence a domestic Chapter 11 case? One reason is to obtain the benefit of avoidance powers that are otherwise unavailable in an ancillary case (*compare* § 1523(a) and § 1521(a)(7)). Another reason is to invoke the expanded reach of an "estate" created under § 541 (which applies to all property of the debtor "wherever located"). This expanded reach, however, is limited only to the extent that such other, non-U.S. assets are also beyond the "jurisdiction and control" of the foreign proceeding.

9. Domestic Creditor Voice in Foreign Proceedings. Sections 1526 and 1527 of Chapter 15 provide that a trustee or other person, if authorized by the Bankruptcy Court and subject to its supervision, may "communicate directly with a foreign court or a foreign representative." Conversely, foreign creditors have the same rights regarding the commencement of, and participation in, an ancillary case as domestic creditors. § 1513.

III. Executory Contracts.

1. Treatment Options. Under the Bankruptcy Code, executory contracts can be **assumed** (honored) or **rejected** (breached) by the debtor. Some cases now suggest that a third option is also available – do nothing (either inadvertently or purposefully) and allow the contract to **"ride through"** the case unaffected. The basis for the "ride through" option is the fact that the Bankruptcy Code does not explicitly compel a debtor to either assume or reject every executory contract. *In re Hernandez*, 287 B.R. 795 (Bankr. D. Az. 2002). If a contract "rides through," however, a debtor will not able to take advantage of its ability to belatedly "cure" any defaults under the agreement. As a result, following the "ride through," any uncured breaches (*e.g.*, late payments) may be immediately enforced (including what might be an otherwise unenforceable right to terminate the contract because of the prior commencement of the bankruptcy case).

2. Executoriness. Only **executory contracts** present a debtor with the choice of assumption or rejection. Common test for executoriness is whether each party has material, unperformed obligations under the contract as of the date the bankruptcy petition is filed. If so, the contract may be executory. If not, the contract would be an asset or liability of the debtor. *In re Robert L. Helms Constr.*, 139 F.3d 702 (9th Cir. 1997) ("If performance is due *to* the debtor, the contract is an asset, which becomes estate property. If performance is due *by* the debtor, it is

[7] Even if a plenary case is commenced, § 305 empowers the Bankruptcy Court to dismiss or suspend proceedings in that case if the purposes of Chapter 15 would be best served by such dismissal or suspension.

a liability of the estate and the nondebtor is an unsecured creditor.").[8] If an agreement has **expired** or been **terminated** according to its terms prior to the commencement of the bankruptcy case, there is no executory contract to assume or reject. *In re AGI Software, Inc*., 199 B.R. 850 (Bankr. D.N.J. 1995). A **post-petition** contract is not subject to assumption or rejection. *In re Leslie Fay Cos*., 168 B.R. 294 (Bankr. S.D.N.Y. 1994).

IV. Payment and Performance Rights and Duties Under Executory Contracts.

General rule is that the commencement of a bankruptcy case automatically stays collection and litigation efforts on pre-bankruptcy charges. Generally speaking, pending assumption or rejection of contract, the nondebtor party must continue to perform. Nondebtor party, however, can seek payment for post-petition charges, which may require pro-rating across the petition date. Automatic stay also prevents enforcement of termination for convenience clauses that might permit the nondebtor party to the contract to terminate at any time (*e.g.*, on 30 days' notice) without relief from the stay. Typically, however, a perpetual license agreement does not entitle the nondebtor licensor to terminate the license except for material breach.

V. Effects of the *Catapult* Decision.

1. Overview. According to a 1999 decision by the Ninth Circuit Court of Appeals (since followed by several other circuits) a debtor may not assume contracts that are "hypothetically" not assignable under applicable non-bankruptcy law (*e.g.*, nonexclusive patent, trademark and copyright licenses). "That is to say, if the debtor-in-possession lacks hypothetical authority to assign a contract, then it may not assume it—even if the debtor-in–possession has no *actual* intention of assigning the contract to another." *N.C.P. Marketing Group, Inc. v. B.G. Star Productions, Inc.*, 129 S. Ct. (2008) (mem.) (statement of Justice Kennedy respecting denial of certiorari). The applicable non-bankruptcy law must prohibit assignment on the rationale that the **identity of the licensee is material** to the agreement.[9] If a contract is non-assignable, and hence non-assumable under *Catapult*, the nondebtor can request relief from the automatic stay to terminate the license. The *Catapult* analysis has been adopted in the Third, Fourth and Eleventh Circuits, while other Courts of Appeal (notably the First Circuit, and possibly the Fifth and

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[8] License agreements are typically considered executory because the licensor usually has ongoing indemnity and warranty obligations (and the license itself is merely a covenant not to sue and, in the case of an exclusive license, a continuing obligation not to license others) and the licensee usually has ongoing payment, noncompetition, quality control and confidentiality obligations. One recent case, however, held that the covenant not to sue (or covenant of quiet enjoyment) that is implicit under a non-exclusive patent license was ***not*** a material, ongoing obligation by the licensor but merely a defense (perhaps only a partial defense) to a possible patent infringement suit. Hence, the agreement was not executory, could not be rejected by the debtor/licensee and remained fully in effect outside the bankruptcy case. *In re Gencor Indus., Inc.*, 298 B.R. 902 (Bankr. M.D. Fla. 2003). *Cf. In re Kmart Corp.*, 290 B.R. 614 (Bankr. E.D. Ill. 2003) (software license agreement is executory).

[9] **See** *In re Catapult Entertainment*, 165 F.3d 747 (9th Cir. 1999); *In re CFLC, Inc*., 89 F.3d 673 (9th Cir. 1996); *Harris v. Emus Records*, 734 F.2d 1329 (9th Cir. 1984); *In re Access Beyond Tech*., 237 B.R. 32 (Bankr. D. Del. 1999); *In re Patient Education Media*, 210 B.R. 237 (Bankr. S.D.N.Y. 1997). Although there is contrary authority, some cases suggest that *Catapult* also applies to **exclusive** licenses. *In re Hernandez*, 285 B.R. 435, 440 (Bankr. D. Az. 2002) ("The Court therefore finds that applicable federal patent law would require the consent of the Licensor to assign the License in this case even if the License is exclusive."); *Gardner v. Nike, Inc.*, 279 F.3d 774, 780 (9th Cir. 2002) ("Thus, we hold that the 1976 Act does not allow a copyright licensee to transfer its rights under an exclusive license, without the consent of the original licensor.").

Second Circuits based on certain recent Bankruptcy Court decisions in *Footstar* and *Adelphia*), have only applied restrictions on assignment where the debtor "actually" seeks to assign the contract, as opposed to merely assuming it. Recently, the Supreme Court suggested that the "division in the courts over the meaning of §365(c)(1) is an important one to resolve for Bankruptcy Courts and for businesses that seek reorganization …. In a different case the Court should consider granting certiorari on this significant question." *Id.*

2. Licensor Protections. Make sure license agreements contain (a) a bankruptcy termination clause (which, despite the general prohibition on *ipso facto* clauses, is rendered enforceable under section 365(e)(2)), (b) a change-of-control termination clause or other restrictions on assignments by operation of law, (c) an anti-assignment clause (*Catapult* issue—if the agreement itself permits assignment, a form of pre-consent, then it will become the source of licensor consent under § 365[10]).

3. Licensee Defenses & Waivers. Licensees, suddenly sensitive to the possibility that a perpetual, fully paid license might be summarily terminated upon the commencement of a bankruptcy case, are now demanding waivers or modifications of the standard insolvency termination clause. In some instances, coupling the insolvency termination clause with another contractual default, such as nonpayment of license fees, is a helpful compromise. Some licensees also request that the termination right be deferred, as opposed to immediate, to permit

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10 A clause that only prohibits assignment absent consent "not to be unreasonably withheld," or that restricts assignment to (i) affiliates of the licensee, (ii) non-competitors of the licensor or (iii) a buyer of substantially all assets of the licensee, is probably tantamount to permitting assignment **absent** these circumstances and will reduce leverage. *In re Hernandez*, 285 B.R. 435 (Bankr. D. Az. 2002) (if a licensor expressly consents to assignment in certain situations without regard to the identity of the assignee, then the contract is effectively removed from the protections afforded under *Catapult*); *In re Quantegy, Inc.*, 326 B.R. 467, 471 (Bank. M.D. Ala. 2005) (where trademark and patent licenses authorized assignment under limited circumstances, licensor had pre-consented where the debtor sought to assign the agreements consistent with those clauses). **But see** *In re Sunterra Corp.*, 361 F.3d 257 (4th Cir. 2004) (following *Catapult* and further holding that contractual permission to assign to any buyer of substantially all assets did **not** remove a license from the ambit of *Catapult;* rather, an express consent to assumption, as opposed to consent to the "conceptually distinct event" of assignment, would be required to override *Catapult*).

the licensee to make alternate arrangements. Licensees are also requesting specific waivers of the licensor's assumption veto power under *Catapult*.[11]

4. *Catapult* Scope. Although it is fairly well-settled that applicable patent and copyright law[12] makes the identity of a licensee material to the inventor and author, respectively (and, hence, renders patent and copyright licenses non-assignable without the consent of the owner), it is less clear whether similar policies apply to **trademarks**. On the one hand, it has been argued that trademarks, by their very nature, are intended to be liberally transferred since they are designed to convey genuineness, even though the products may not be actually manufactured by the trademark owner. On the other hand, some recent decisions recognize that a trademark owner's right to control the abilities and qualifications of its licensees necessarily makes a trademark personal to the owner. **See** *In re N.C.P. Marketing Group, Inc.*, 337 B.R. 230 (D. Nev. 2005) (under federal common law of trademarks, trademarks are personal to the owner and non-assignable to a third party without the consent of the licensor); *Miller v. Glenn Miller Productions*, 318 F. Supp. 2d 923, 938 (C.D. Cal. 2004) ("[T]he Court finds that the policies underlying the sub-licensing rule in patent and copyright law apply with equal force to trademark law. Accordingly, a trademark licensee … may not sub-license without express permission from the original licensor."); *In re The Travelot Company*, 286 B.R. 447, 455 (Bankr. S.D. Ga. 2002) (under the Lanham Act, grant of a non-exclusive trademark license is personal to the assignee and thus not freely assignable to a third party).

5. Historical Defaults. On April 14, 2005, Congress passed the *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*. Most provisions of the act are effective for bankruptcy cases commenced on and after October 17, 2005. Although the amendments principally address perceived abuses in consumer bankruptcies, a fair number of provisions affect business bankruptcies as well. There were no amendments that specifically addressed the *Catapult* decision or the treatment of intellectual property licenses in Chapter 11 cases. The

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[11] For example*: Notwithstanding the foregoing: (i) in the event of a merger, consolidation or acquisition of all or substantially all of the assets or stock of Licensee, Licensee may assign its rights under this Agreement to the resulting entity upon at least thirty (30) calendar days prior written notice to Licensor,* provided that*, the Conditions of Assignment (as defined below) are met; and (ii) in the event of Licensee's Insolvency, a trustee in bankruptcy or Licensee (as a debtor in possession) may assume this Agreement under 11 USC § 365 (or its successor statute) and assign Licensee's rights under this Agreement upon at least thirty (30) calendar days prior written notice to Licensor,* provided that*: (a) the Conditions of Assignment (as defined below) are met; and (b) Licensee agrees to reimburse Licensor, as an actual pecuniary loss under 11 USC § 365, for all reasonable attorneys' fees and costs incurred by Licensor in connection with such assumption and/or assignment. "Insolvency" means (i) a party's general failure or inability to pay its debts as they become due, cessation of its business, or admission of its inability to pay its debts, (ii) the entry of an order for relief by or against a party under Title 11 of the United States Code (or any other similar proceeding for the arrangement, adjustment or composition of debts under any state, federal or foreign law providing for the relief of debtors), (iii) the appointment of, assignment to, or the taking of possession by, a receiver, trustee, assignee, custodian, liquidator or other similar agent or officer of a party, or of all or a substantial part of its property, or (iv) any corporate action by a party to authorize any of the actions in clauses (ii) and (iii) hereof. "Conditions of Assignment" means that assignee (i) is not a competitor of Licensor, (ii) is not otherwise a licensee from Licensor, (iii) possesses sufficient resources (financial or otherwise) to perform Licensee's obligations under this Agreement, and (iv) signs an amendment with Licensor assuming all of the obligations of Licensee under this Agreement.*

[12] Section 365(c)(1) also applies to debtors that are contractors with government agencies under the Anti-Assignment Act, 41 U.S.C. § 15, which bars the assignment of government contracts.

amendments do, however, codify a decision by the Court of Appeals for the Ninth Circuit in *In re Claremont Acquisition Corp., Inc*., 113 F.3d 1029 (9th Cir. 1997). *Claremont* essentially held that a debtor cannot assume an executory contract if the debtor has committed "historical" defaults that, by definition, are incapable of being cured. The new amendments codify this result by clarifying that a debtor is only not required to cure **penalty** rates or **penalty** provisions – meaning that other nonmonetary obligations must be cured as a condition to assumption. The amendments, however, add a carve-out to this rule for nonmonetary obligations arising under real property leases – such obligations need not be cured but merely performed following assumption. The upshot of these two amendments is that the cure of nonmonetary defaults **under executory contracts** (such as license agreements) is still required – if such defaults are "historical" in nature, then a debtor may face substantial difficulties in assuming such contracts.

VI. Assumption.

1. <u>General</u>. If a debtor decides to assume a contract, it must cure defaults, compensate for damages, and provide adequate assurances of future performance. "Cure" means the repayment of all pre-petition claims (and any post-petition claims that have not been satisfied in the ordinary course as administrative expenses) and includes payment of interest, and possibly attorneys' fees, if provided for in the license. *In re Entertainment, Inc.*, 223 B.R. 141 (Bankr. N.D. Ill. 1998).

2. <u>Cross-Defaults</u>. Assumption may also provide an opportunity to collect outstanding claims due under related agreements. Some agreements, for instance, permit termination on account of any unpaid amounts due to the non-debtor. Generally speaking, although such cross-default provisions are not *per se* unenforceable, they will not be interpreted to thwart a debtor's bankruptcy right to assume an "unrelated contract." *In re Kopel*, 232 B.R. 57 (Bankr. E.D.N.Y. 1999).

3. Assumption Terms. In cases where a license is being assumed, one should consider an amendment to the license to specify the cure payment, consent to the assignment, and obtain a release.[13]

VII. Rejection.

1. General. The rejection of a license agreement by the debtor-licensee is tantamount to a breach of the license agreement as of the date of commencement of the bankruptcy case.

2. Termination or Breach? There is currently some dispute over whether "rejection" constitutes termination of the agreement or merely a breach of the agreement permitting the nondebtor party to the agreement to elect remedies. Section 365 uses both terms ("rejection" and "termination"), suggesting that they have different meanings. *Compare McLaughlin v. Walnut Properties, Inc.*, 119 Cal. App. 4th 293 (2004) ("We … adopt the emerging view that the rejection of an unexpired lease is no more than a breach and does not terminate the lease."), *and In re Treesource Indus., Inc.*, 363 F.3d 994, 998 (9th Cir. 2004) ("The termination or expiration of the lease occurred when [lessee/debtor] rejected the lease."). *See also In re Lavigne*, 114 F.3d 379 (2nd Cir. 1997) (the deemed rejection of an insurance policy was not a termination excusing the insurer's obligation to offer "tail" coverage).

3. Rejection of an Assumed Agreement. The rejection of an assumed contract (which **can** happen) gives rise to an administrative expense for damages.

4. Post-Rejection Steps. In rejection scenarios, consider execution of a termination letter to recover intellectual property, software and documentation.[14]

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13 For example: *Licensor consents to the assumption by Licensee of the License Agreement under Section 365(b) of the Bankruptcy Code. Licensee shall pay Licensor the amount of $X, on account of outstanding license fees and other charges for the period from December 12, 2008, through December 12, 2010 (the "Cure Payment"), in full cure and satisfaction of defaults and losses under the License Agreement as of the commencement of the Chapter 11 Case pursuant to Section 365(b)(1) of the Bankruptcy Code. The License Agreement shall be deemed assumed by Licensee as of the date of entry of the order of the Bankruptcy Court confirming the Plan (the "Assumption Date"). Licensee will take the necessary and appropriate steps to obtain the approval by the Bankruptcy Court of this agreement at the hearing. The Cure Payment shall be deemed allowed by this agreement without necessity of any further filings or amendments, including any proof of claim. Upon the Assumption Date, the Debtor shall be deemed to have waived and released Licensor from any and all claims, demands, and causes of action that it has or may have against Licensor arising under the License Agreement. It is the intention of Licensee that this agreement shall be effective as a full and final release of all claims, debts, rights and obligations against Licensor. Accordingly, Licensee waives the benefit of the provisions of California Civil Code § 1542 (or any similar applicable statute). Licensee acknowledges and agrees that this agreement shall not operate or be construed as consent or authorization to expand the scope of use permitted under the License Agreement. Licensor's consent to the assumption of the License Agreement by this agreement shall not operate or be construed as consent to any subsequent assignment of, or otherwise affect the restriction on assignment contained in, the License Agreement. Licensee acknowledges that a breach of this agreement shall constitute a default under the License Agreement.*

VIII. Debtor as Licensor Issues.

1. General. Section 365(n) grants special protection to licensees. If a debtor-licensor rejects the license agreement, the licensee can elect to either (a) retain its rights under the agreement for the duration of the agreement plus any extensions, provided that any royalty obligations are satisfied (without offset), or (b) treat the agreement as terminated. Expressly included among the rights that may be retained by the licensee are any exclusivity provisions under the license. Section 365(n) also permits continued rights under "supplementary" agreements (*e.g.*, source code escrows).

2. License in Effect. However, the license must be in effect as of the date of the commencement of the bankruptcy case for the statute to apply. *In re Storm Technology, Inc.*, 260 B.R. 152 (Bankr. N.D. Cal. 2001).

3. Deadline to Elect. Although the non-debtor party to the license can elect to retain its rights under the license following rejection, the statute is silent about the deadline to make the election and Bankruptcy Courts have the ability to set binding bar dates. *In re PCH Holding, LLC*, 306 B.R. 800 (E.D. Va. 2004).

4. Scope of Intellectual Property. The intellectual property that is subject to § 365(n) only applies to **domestic** patents and copyrights (*i.e.*, patents "protected under title 35," and copyrights "protected under title 17").[15] Trademarks, moreover, are excluded from the scope of "intellectual property" (according to the legislative history, at the request of franchisors concerned about post-rejection use of marks); hence, there is a risk that rejection may deprive a licensee of the ability to use marks even though it remains able to distribute copyrighted works. *In re Centura Software, Inc.*, 281 B.R. 660 (Bankr. N.D. Cal. 2002); *In re HQ Global Holdings, Inc.*, 290 B.R. 507 (Bankr. D. Del. 2003); *In re Exide Technologies*, 340 B.R. 222 (Bankr. D. Del. 2006). If a trademark license is rejected, however, the licensee would have a claim for damages arising from the loss of use of the mark.

5. Recitation in Agreements. Licensees typically ask for regurgitation of § 365(n) in the license agreement – issues arise when the suggested language varies from the statute.

6. Cross Licenses. In some instances, the licensee is treated as the contractual owner of modifications or other consulting work product that it makes, or has made, to the licensed intellectual property (usually for internal use purposes only, not for further re-sale or transfer).

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[14] For example: *Reference is made to the License and Services Agreement dated as of December 12, 2008 (as supplemented and amended, the "License Agreement"), between Licensor and Licensee. Licensee is a debtor in the above-referenced under Chapter 11 case. The License Agreement has been rejected, effective December 12, 2011, pursuant to Section 365 of the Bankruptcy Code, under the Licensee's chapter 11 plan of reorganization. Pursuant to § 6 of the License Agreement, Licensee hereby certifies that, after December 12, 2011, Licensee has no further rights in and to, has ceased using, and will deinstall the software licensed to Licensee by Licensor under the License Agreement. Licensee further certifies that all software, including partial copies and modified versions, and documentation provided to Licensee under the License Agreement has been destroyed or will be returned to Licensor.*

[15] In the *Qimonda* litigation, discussed below, the foreign representative has pointed out that a licensee's ability to invoke § 365(n) to retain its licensed patents would not protect manufacturing and sales outside the U.S.

In such cases, the licensor typically demands a license back from the customer in order to protect itself, and its other customers, from infringement claims.[16] If the customer commences a Chapter 11 case, the licensor (in its additional capacity as a cross-licensee to the modifications) should be careful to exercise its § 365(n) rights in the event the customer decides to reject the software license. The debtor-licensee, however, has the unfettered right to reject the master license, perhaps destroying the sublicense in the process and nullifying any ability of the non-debtor, sub-licensee to make the § 365(n) election.

IX. Effects of the *Qimonda* Decisions.

1. Overview. Qimonda AG is a German producer of DRAM chips and holds approximately 12,000 patents, approximately 4,000 of which were issued in the U.S. After a collapse in the price of DRAM chips in 2008, Qimonda commenced German insolvency proceedings in January 2009. The foreign representative of Qimonda commenced an ancillary case under Chapter 15 in the Bankruptcy Court for the Eastern District of Virginia in July 2009. The foreign proceeding was recognized by the Bankruptcy Court as a foreign main proceeding, triggering certain automatic relief under §§ 1502(7), 1520. As permitted by the "additional relief" provisions of § 1521, a supplemental recognition order was also entered by the Bankruptcy Court. That order provided that § 365 (among other specified sections of the Bankruptcy Code) would also apply in the Chapter 15 case -- according to the foreign representative, the reference to § 365 "was not requested by any party" (although the supplemental order itself was issued at his request). The foreign representative later sought to delete or modify the applicability of § 365 (as further permitted under § 1522(c)), on the grounds that German insolvency law should control the disposition of executory contracts. German insolvency law would apparently permit the representative to "elect non-performance" of intellectual property licenses without any corresponding residual rights in favor of licensees. Various licensees of the German patents complained that they would lose their election rights under § 365(n) and, if the foreign representative in fact proceeded to terminate the German licenses, be forced to re-bid for patent rights they had already purchased.

2. Bankruptcy Court Decision (November 2009). The Bankruptcy Court agreed with the foreign representative that the purposes and policy of Chapter 15 compelled a single, systematic treatment of international patents, even if domestic licensees would be adversely affected. A Chapter 15 ancillary proceeding "should supplement, but not supplant" the foreign proceeding. According to the court, "all the patents should be treated the same. There should not be disparate results simply because of the location of a factory or research facility or corporate office. This would be the result if the supplemental order were left in place. It is clear that the inclusion of § 365 in the supplemental order was improvident. It had unintended consequences that significantly and adversely affect the main proceeding in Germany." The

[16] For example: *Licensee owns any inventions and patents issuing thereon for any Licensee Software Modifications that a Licensee employee conceives and reduces to practice during the term of this Agreement and in connection with the services authorized hereunder ("Licensee Patents"). Licensee grants to Licensor a non-exclusive, irrevocable, perpetual, worldwide, non-transferable (except insofar as this Agreement may be assigned), fully paid and royalty-free license under such Licensee Patents to make, use, sell, offer to sell, import, license, or otherwise transfer the Licensee Software Modifications in accordance with this Agreement. Licensee further irrevocably covenants not to sue any customer of Licensor for infringement of any Licensee Patents where the infringement arises from the customer's use of the Licensee Software Modifications.*

court, thus, amended the supplemental recognition order to make § 365 applicable *only if* the foreign representative rejected an agreement under that section as opposed to under German law.

3. Appellate Court Decision (July 2010). Eight of Qimonda's licensees (including Qimonda AG's corporate predecessor in interest, Infineon Technologies) then appealed the Bankruptcy Court's decision on the grounds that (a) § 365 applied automatically upon entry of the recognition order, and (b) the principles of comity and cooperation embedded in Chapter 15 (and particularly the protection of creditors under §1522(a)) compelled the adoption of § 365 in the Chapter 15 case. The district court reversed and remanded the proceedings to the Bankruptcy Court on the grounds that the court had insufficiently balanced the respective interests of the foreign representative and creditors in order to assure their "sufficient protection," as required by §1522(a).[17] The district court did agree, however, that § 365 did not automatically apply upon recognition since that section is plainly not listed in § 1520. Hence, the decision to make § 365 applicable was properly left to the discretion of the court under § 1521 (in other words, § 365, like other non-enumerated sections in § 1520, could be adopted or conditioned on a case by case basis). Last, the district court considered whether the public policy override under § 1506 would permit the Bankruptcy Court to deny comity to the foreign administrator's application of German law to repudiate the license agreements – in other words, does § 365(n) embody the fundamental public policy of the U.S. such that honoring German law would flout U.S. policy? On the one hand, the legislative history to § 365 reflects Congressional recognition of the national importance of patent innovation. On the other hand, Congress also adopted Chapter 15 without expressly subjecting foreign debtors to the requirements of § 365. The court remanded this question as well for further consideration by the Bankruptcy Court.

4. Update. An evidentiary hearing on the remanded motion to amend the supplemental recognition order was held by the Bankruptcy Court in early March 2011 and post-hearing argument is scheduled for March 30, 2011. The foreign representative and the appellants have each submitted competing forms of findings of fact and conclusions of law in support of their respective positions.

5. Limitation. The definition of intellectual property under the Bankruptcy Code applies to patents "protected under title 35," and copyrights "protected under title 17." In *Qimonda*, the patents were" issued under the laws of various nations." An election to retain licensed rights would under § 356(n) would only have applied to U.S. patents and would not have protected domestic licensees in other jurisdictions.

6. Query. What if Qimonda's foreign representative had also commenced a Chapter 11 case on the theory that the intellectual property licensed to U.S. customers was intangible property located within the territorial jurisdiction of the United States? Notably, when defining

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[17] According to the court, the record was "anemic." The district court wondered how the continuation of existing non-exclusive licenses would impair the foreign representative's effort to sell or further license the patent portfolio. Interestingly, Qimonda AG's domestic subsidiaries, which had earlier settled a dispute over the ownership of the Qimonda patent portfolio, supported the foreign representative's efforts because they would have received "earn out" payments from future exploitation of the patents for distribution to their creditors. The foreign representative has since confirmed that Qimonda is willing to license its patent portfolio at a reasonable royalty to be negotiated, or to be determined by a neutral, third party arbitrator appointed by the World Intellectual Property Organization.

the "territorial jurisdiction of the United States," Chapter 15 expressly includes the intangible property of a foreign debtor that is "deemed under applicable nonbankruptcy law to be located" within that territory, including any property subject to attachment or garnishment in a federal or state court in the U.S. § 1502(8). Under the UCC, software and other intellectual property is considered a "general intangible" to which a security interest may attach and be perfected, although the anti-assignment restrictions under the UCC may restrict the enforceability of that security interest (discussed further below). If a domestic Chapter 11 or 7 case had been commenced by the foreign representative, § 365 would have been automatically applicable, and not subject to later exclusion. Moreover, under Chapter 15, following the entry of a recognition order, it is possible that the domestic creditors of Qimonda AG could have commenced an involuntary Chapter 11 or Chapter 7 case. §§ 1528, 1531 (recognition of a foreign main proceeding, for purposes of commencing an involuntary case under § 303, is "proof that the debtor is generally not paying its debts as such debts become due").

X. Effects of Sales of IP by a Debtor/Licensor.

A sale "free and clear" by a debtor of property that is subject to a lease (in the case of real property, for example) or a license (in the case of intellectual property, for example), may deprive the lessee/licensee of its rights to further use the property since a lease or a license is a type of "interest" that may be stripped from the property under section 363(f) of the Bankruptcy Code. *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC,* 327 F.3d 537 (7th Cir. 2003) ("In this case of first impression at the circuit level, we are asked to reconcile two distinct provisions of the Bankruptcy Code: 11 U.S.C. § 363(f), which authorizes the sale of a debtor's property free of any 'interest' other than the estate's, and 11 U.S.C. § 365(h), which protects the rights of the lessee when the debtor rejects a lease of estate property. … Because Precision's right to possess the property as a lessee qualifies as an interest for purposes of section 363(f), the statute on its face authorized the sale of Qualitech's property free and clear of that interest."); *FutureSource LLC v. Reuters Ltd.,* 312 F.3d 281 (7th Cir. 2002) (sale of intellectual property "free and clear" extinguished licensee's right to use copyrighted material under license agreement). These decisions suggest that a section 363(f) sale of copyrights by a licensor may deprive its licensees of their rights under sections 365(n) of the Bankruptcy Code. The only apparent remedy to the loss of rights under subsections 365(h) and (n) is to seek adequate protection under section 363(e). What happens when (1) a debtor/licensor sells its intellectual property to a third-party buyer that refuses to take an assignment of pre-existing license agreements, (2) the debtor/licensor then rejects the license agreements, and (3) the licensee makes a section 365(n) election to retain its licensed rights subject to all royalty payments due. Who gets the royalties? *In re CellNet Data Systems, Inc.*, 327 F.3d 242 (3rd Cir. 2003) (the debtor/licensor, to the buyer's chagrin).

XI. Preference Exposure.

1. <u>Intellectual Property Defenses</u>. Preferential transfers made by a debtor within 90 days prior to the commencement of the case may be avoided and recovered. Although there are many defenses, there are also many opportunities to settle this possible exposure. A recent Delaware bankruptcy case suggests that continued use of licensed intellectual property by a debtor licensee may provide a "new value" defense to the licensor if it is sued for a preference. *In re Discovery Zone, Inc., et al.,* 300 B.R. 856 (Bankr. D. Del. 2003). Another defense to

consider applies to situations where an annual maintenance or support services payment is made by the debtor. Even if the payment is not made in the ordinary course (*i.e.*, the payment is unusually late), such payments may be considered "pre-payments" for services to be rendered over the course of the support period and, hence, may not qualify as transfers on account of "antecedent debt" (a necessary element for preference liability). Put another way, since a licensor cannot refuse to refund all or part of an annual support fee if it decides to discontinue support, it follows that no "debt" is created unless and until the support is actually delivered by the licensor over the course of the support period.

2. Recent Limitations. Under recent amendments to the Bankruptcy Code, enacted pursuant to the *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, transfers under $5,000 are now immune from avoidance. In addition, Congress also eased the requirements for the "ordinary course of business" defense to avoidance – previously, a transfer had to be made both in the ordinary course as between the debtor and the particular creditor (a subjective test) **and** in the ordinary course according to industry standards generally (an objective test). Now, compliance with either test will immunize a transfer from avoidance. Last, if the alleged preference is less than $10,000, the preference action must be brought in the defendant's home forum (as opposed to the Bankruptcy Court).

XII. Security Interests.

1. Restrictions on Collateral Assignments. Many agreements (including permits, licenses or franchises) contain terms that bar the counter-party from granting a security interest in the licensed software or other general intangibles (which includes intellectual property such as patents, copyrights and trademarks). Under the revised UCC, however, such clauses are unenforceable to the extent they would impair the creation, attachment or perfection of a security interest or give rise to a default or right of termination under the agreement. UCC § 9-408(a). The reasons for this are that (a) many lenders often take a blanket security interest in all assets of a borrower, including intangible assets such as intellectual property rights, and (b) some lenders ascribe value to a borrower's software systems and intellectual property rights, even through the lender may not (for the reason described below) be able to take advantage of such rights without the licensor's consent (and, despite, the UCC's override, the lien on "proceeds" of the general intangible will remain intact and enforceable in a possible bankruptcy of the licensee/debtor). By invalidating the prohibition on granting security interests, the UCC protects licensees from inadvertently breaching licenses by granting blanket security interests under unrelated financing arrangements. **Even though the clause is unenforceable, it should be kept in the license agreement.** Why? Because the UCC still honors the clause vis-à-vis the licensor in the enforcement context – the lender cannot use the software if it forecloses its security interest, and the licensor is not required to recognize the security interest, render performance to the secured party or permit any access to documentation, trade secrets or confidential information. UCC § 9-408(d).

2. Means of Perfection. As a general rule of thumb, in order to be effective, a security interest in (i) a **registered copyright** must be recorded with the Copyright Office, (ii) an **unregistered copyright** must be perfected by filing a financing statement under the UCC, (iii) a **patent** must be perfected by filing a financing statement under the UCC, and (iv) a **trademark** must be perfected by filing a financing statement under the UCC.