

PLI's Intellectual Property Institute 2010

BANKRUPTCY ISSUES IN COPYRIGHT

By

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I. INTRODUCTION

Software licenses are copyright licenses. The license specifies the extent to which “copying” is permitted under the license. In this article, we address various bankruptcy issues related to computer software, computer software licenses and other intellectual property assets. First, we provide basic background applicable to licensor/licensee bankruptcies. Second, we discuss the Intellectual Property Bankruptcy Protection Act of 1988 (Bankruptcy Code Section 365(n), including identification of risk and potential strategies for minimizing those risks. Third, we consider issues relating to the assumption of technology licenses by debtor-licensees. Fourth, we provide an overview of benefits and risk of working with a financially troubled licensor. Fifth, we discuss the necessity of perfecting security interests. Lastly, we discuss the dischargeability of copyright infringement judgments (and other IP infringement judgments) in bankruptcy.

II. LICENSE BANKRUPTCY BASICS

Types of Possible Bankruptcies.²

Chapter 11. If a company files a petition under Chapter 11 of the Bankruptcy Code the business remains in operation, controlled by its officers as a “debtor-in-possession.” The goal of Chapter 11 is to reorganize the business and continue operating. Upon a motion of a creditor, the Court may convert a Chapter 11 case to one under Chapter 7 on the basis that the debtor-in-possession is unable or unlikely to effectuate a reorganization plan or that the business is continuing to lose its value and such losses are prejudicial to creditors. Bankruptcy Code § 1112(b)(2). Start-up corporations do not often file under Chapter 11 to reorganize, as the company has generally used up its financing, and is not generating any positive cash flow.

² This discussion refers to corporate bankruptcies unless expressly stated otherwise. Bankruptcies filed by individuals can involve different issues that are not addressed here. As used herein, “Bankruptcy Code” refers to Title 11 of the United States Code, and “Section” refers to the Bankruptcy Code.



Such a company is generally not capable of proposing a feasible plan of reorganization because it has no way to cover its current and expected costs and pay its creditors. In a Chapter 11 reorganization, cash and cash flow are king.

“Liquidating 11”. This classification is not a formal category, but a company may file a plan under Chapter 11 to remain in control of the liquidation process. The copyright would be sold and the license of the copyright would likely be assumed and sold, if the license has prospective value, or rejected, if there is no current realizable value, or if the Debtor is unable to provide required services to support an assumed license.

Chapter 7. If a company files a petition under Chapter 7, all of the assets are transferred to the control of a trustee. Except in unusual circumstances, the business will shut down immediately. (Occasionally, if the value of the business would decline significantly if it ceased operation, a trustee may obtain an order allowing the continued operation of the business. Bankruptcy Code § 721. (This order to continue business operations is the exception rather than the rule.) The trustee’s primary jobs are to collect all of the assets, sell them for the highest value, determine the priority and validity of creditors’ claims, and distribute the proceeds accordingly. The trustee is also responsible for investigating the financial affairs of the Debtor, and may set aside preferential or fraudulent transfers (discussed below), or certain types of liens. See Bankruptcy Code § 704 (describing duties of the trustee); Bankruptcy Code §§ 544-549 (describing trustee’s Avoidance Powers).³

³ Upon commencement of a bankruptcy case a bankruptcy estate is created, which is comprised of all of the Debtor’s legal or equitable interests in property as of the commencement of the bankruptcy case (with some exceptions for individuals). 11 U.S.C. § 541. The bankruptcy estate here is referred to as the “Estate,” and the bankrupt entity, whether a Chapter 7 debtor or the debtor-in-possession of a Chapter 11 is referred to as the “Debtor.” Estate property includes all of the Debtor’s contract rights, and intellectual property rights. See generally *Dailey v. Smith*, 684 N.E.2d 991, 993, 292 Ill. App. 3d 22, 24 (Ill. App. Ct. 1997); *Matter of Plunkett*, 23 B.R. 392, 393-394 (Bankr. E.D. Wis. 1982); H.R. REP. NO. 95-595, at 175-176 (1977). In bankruptcies of technology companies, particularly in Chapter 7, intellectual property rights are often the only valuable assets.



Assignment for the benefit of creditors. An assignment for the benefit of creditors is a common law device (the statutory assignment was repealed in California in 1980) in which the assets are “assigned” to an assignee fiduciary, who then liquidates them, and thereafter distributes the proceeds to creditors. An assignee has some of the rights of a trustee in bankruptcy, but does not have, e.g., the power to assume and assign.

Liquidation under California Corporations Code § 1800. California Corporations Code section 1800 authorizes a petition in voluntary dissolution if a sufficient number of shareholders or persons authorized by the Articles of Incorporation seek liquidation.

Abandonment of business. Abandonment is not uncommon for many technology licensors. The business is simply closed. Rather, there is no formal liquidation, there is a “walk away.” As such, abandonment creates a problematic situation for a licensee; some modicum of protection is available per Exhibits A, B and C. A security interest in the technology would also be useful as discussed below in Section .



Automatic Stay.

Section 362. The automatic stay, set forth in section 362 of the Bankruptcy Code, is the core protection provided to a bankrupt debtor. It occurs “automatically” upon the filing of a bankruptcy petition. Section 362 prohibits anyone from, among other things:

Bringing an action or continuing any suit against the Debtor that could have been brought before the bankruptcy case began;

Taking any act to obtain possession of property of the estate or to exercise control over such property (but obtaining escrowed materials in a Source Code Escrow may be an exception, see Section 365(n)(3) – see discussion below at Section ;

Creating, perfecting or enforcing any lien against the property of the estate; or

Taking any action to collect or recover a claim against the Debtor that arose before the case began.⁴ Bankruptcy Code § 362(a).

Violation of Stay. Generally, any act against the Debtor, including terminating a contract or license, taking assets, or otherwise taking an action adverse to a Debtor or the Estate’s property, will be a violation of the stay and should not be done without first obtaining an order for relief from the stay from the bankruptcy court where the case was filed. Violations of the stay (and in particular, actions taken with knowledge of the bankruptcy) can result in serious repercussions. For example, in *Computer Communications, Inc. v. Codex Corp.*, 824 F.2d 725 (9th Cir. 1985), the Ninth Circuit upheld a \$4,750,000 damages award against a company that terminated a contract to purchase computer equipment based on a bankruptcy-triggered clause without first obtaining relief from the stay.

⁴ This is not a complete list. If there is any question regarding a violation of the automatic stay, reference should be made to the Bankruptcy Code.



Relief from Stay. To obtain relief from a stay, a party must obtain an order from the Bankruptcy Court pursuant to either a motion or a stipulation entered into with the trustee or debtor-in-possession. In general, relief from a stay will be granted for good cause shown, including the “lack of adequate protection of an interest in property” and the likelihood that no reorganization is possible, or that the asset involved is not critical to the prospects of reorganization. See Bankruptcy Code § 362(d).

Ipsso Facto Clauses.

Provisions in licenses and executory contracts for automatic termination upon a debtor’s bankruptcy or insolvency are not enforceable in a bankruptcy case against the Debtor. Section 365(e)(1) provides:

Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease 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;
- (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.

Technology licenses almost invariably contain such clauses (as does Exhibit B), but as provided in the Code, and in *Computer Communications, Inc. v. Codex Corp.*, 824 F.2d at 729-30, they are not enforceable against Debtors.

Assumption or Rejection of Licenses.



Executory Contracts.

Under Bankruptcy Code Section 365(a), a debtor may assume or reject “executory contracts.” An executory contract is any agreement that contains materially unperformed obligations respecting both parties where the failure to perform would constitute a material breach. Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 51 Minn. L. Rev. 439, 460 (1972-1973).⁵ Most software licenses are executory contracts because the licensee has obligations to pay license fees, maintain confidentiality of the software, use the software appropriately or other material obligations, and the licensor has obligations such as indemnification and software maintenance and support.⁶ A contract which is not executory is not subject to rejection. Debtor-licensors may reject a license on the grounds, *inter alia*, that meeting their obligations under the license agreement constitutes too great a burden on the bankruptcy estate. A debtor’s right to assume or reject an executory contract is vital to the basic purpose of a Chapter 11 reorganization under the Bankruptcy Code.⁷

Time to assume or reject.

Often the mere delay of installation of a license can crucially impact the licensee’s business. In a Chapter 11 case, the debtor-in-possession may assume or reject an executory contract at any time before the confirmation of a plan. Bankruptcy Code Section 365(d)(2). In the interim, the Chapter 11 debtor may simply suspend its performance while deciding what action to take. The debtor, however, can enforce a contract in this interim period. *Matter of Whitcomb & Keller Mortgage Co. Inc.*, 715 F.2d 375, 379 (7th Cir. 1983).

The court may, on the request of any party to such contract, order the debtor-in-possession to determine within a specified period of time whether to assume or reject the

⁵ See *In re Robert L. Helms Const. & Devel. Co., Inc.*, 139 F.3d 702, 705 (9th Cir. 1998).

⁶ It is well settled that a technology or software license constitutes an executory contract under Bankruptcy Code Section 365. See *In re Select-A-Seat Corp.*, 625 F.2d 290 (9th Cir. 1980); accord *In re CFLC, Inc.*, 89 F.3d 673 (9th Cir. 1996).

⁷ *In re: TWA*, 2001 Bankr. LEXIS 267 (Bankr. D. Del. Mar. 12, 2001).



executory contract. Bankruptcy Code Section 365(d)(2). Such a motion is substantially stronger if the license itself states that “time is of the essence” in contract performance. See Exhibit B. If the possible insolvency of a party to a license is an issue when the license is created, the other party should insist on language that specifies the time in which the contract would be assumed or rejected. While this may not be specifically enforced by a Bankruptcy Court, it provides support for the motion.

In a Chapter 7 bankruptcy proceeding, such a delay is generally not an issue. A Chapter 7 trustee does not operate the business, and thus will have no reason to assume a license. Rejection is automatic 60 days after a trustee is appointed. Bankruptcy Code Section 365(d)(1). The only reason a Chapter 7 trustee would assume would be in connection with a sale.

Requirements for Assumption of Executory Contract.

Section 365(a) allows the trustee (or debtor-in-possession) to assume executory contracts. Subsection (b) requires that, if there has been a default in the contract, the trustee may not assume it unless the trustee cures the default or provides adequate assurance to the other party that the default will be promptly cured and the other party will be compensated for any actual financial loss resulting from the default. The trustee must also provide adequate assurance of future performance. If a licensor files Chapter 11, and seeks future royalties, it must assume the contract, assure the buyer of its future performance and continue to act as licensor.

III. BANKRUPTCY CODE SECTION 365(N) (THE INTELLECTUAL PROPERTY BANKRUPTCY PROTECTION ACT)

Overview of Bankruptcy Code Section 365(n).

The Intellectual Property Bankruptcy Protection Act was enacted October 18, 1988. It represents a significant development affecting software licensors and licensees, and other



intellectual property licensors and licensees. The Intellectual Property Bankruptcy Protection Act added Bankruptcy Code Section 365(n) and several new definitions to Bankruptcy Code Section 101. See Bankruptcy Code §§ 101, 365(n) (Supp. 1989).⁸

Bankruptcy Code Section 365(n) was enacted to provide certain protections to licensees of a “right to intellectual property.” The Intellectual Property Bankruptcy Protection Act seeks to ensure that a licensee of intellectual property receives the benefit of its bargain, even after the licensor’s bankruptcy. Section 365(n) grants a new, statutorily defined license. “Intellectual Property” is defined in Bankruptcy Code 101(35A) to include “(A) trade secret, (B) invention, process, design, or plan protected under title 35 [i.e. patents], (C) patent application; (D) plant variety, (E) work or authorship protected under title 17 [i.e. copyrights]; or (F) mask work protected under chapter 9 of title 17; to the extent protected by applicable nonbankruptcy law.” Trademarks are expressly excluded. This exclusion may prove especially troublesome in connection with software distribution licenses where the distributor-licensee is distributing a trademarked software product. Notably, the definition of intellectual property in the Bankruptcy Code does not appear to include copyrights and patents under foreign laws.

Section 365(n) provides a licensee with two options if a debtor-licensor rejects the license: (i) treat the rejection of the license as a material breach under Section 365(n)(1)(A) and terminate the license agreement, or (ii) elect to retain its license under Section 365(n)(1)(B) with certain modifications.

Option 1: Treating Rejection of License as a Material Breach.

Under the first option, the licensee loses its license to the software but obtains a general unsecured claim for money damages under Section 365(g) of the Bankruptcy Code. Generally,

⁸ This legislation, in effect, overturned the Fourth Circuit’s ruling in *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985) *cert. denied*, 475 U.S. 1057 (1986), which upheld the bankruptcy court’s order approving the debtor-licensors’ rejection, under the business judgment rule, of a non-exclusive license of its patented metal coating process.



under this first option, licensees receive very little as unsecured creditors and lose the right to continue using the licensed software. The licensee would be in the same position as any other party whose contract was rejected and treated as a general unsecured creditor with a pre-petition claim.

Option 2: Licensee Retention of License (subject to limitations).

Under the second option, the licensee retains a license “as such rights existed immediately before the case commenced.” Bankruptcy Code § 365(n)(1)(B). The licensor is prohibited from interfering with the licensee’s exercise of its retained rights. Bankruptcy Code § 365(n)(2)(A). The licensor, however, is relieved of its affirmative obligations under the license to include duties such as maintenance, training support, providing enhancements or new releases, warranty obligations and indemnification obligations. Because licensees under Section 365(n) only retain the rights that exist at the time of licensor’s bankruptcy, licensees should ensure that the license agreement expressly includes source code and maintenance rights within its scope. If the debtor-licensor continues to work on the licensed technology post-petition and then rejects the license, Section 365(n), arguably, would not give the licensee rights to the post-petition work under Section 365(n).⁹ Accordingly, even with access to the source code, the licensee’s continuing rights to use the software may be insufficient because the licensee may be unable to maintain and support the software without the licensor’s assistance. See discussion below in Section III. .

If the licensee chooses to retain its license, it is obligated to continue making royalty payments due under the license. The Ninth Circuit has read “royalty payments” broadly to mean all of the payment obligations to the licensor – even payments that are intended in the contract as compensation for the licensor’s future services were deemed “royalties” for this

⁹ See *BioSafe Int’l., Inc. v. Controlled Shredders, Inc. (In re Szombathy)*, Nos. 94B15536, 95A01035, 1996 WL 417121, at *11-*12 (Bankr. N.D. Ill. July 9, 1996).



purpose. *In re Prize Frize, Inc.*, 32 F.3d 426 (9th Cir. 1994). See discussion below in Section III. for a recommended strategy to address this issue. The licensee must also waive any right of setoff for damages resulting from the rejection and any administrative priority claim under Bankruptcy Code Section 503(b) arising from the performance under the license. See Bankruptcy Code § 365(n)(2). Accordingly, it is very important that the licensee ensure it has sufficient rights under the license as of the bankruptcy petition to continue using the licensed software. We discuss below several strategies to utilize Section 365(n) effectively.

Unless and until the debtor-in-possession rejects the license, on the written request of the licensee, the debtor-in-possession must perform the license or provide the licensee such intellectual property held by the debtor-in-possession and not interfere with the licensee's rights under the license, including any right to obtain the intellectual property from a third party. Bankruptcy Code Section 365(n)(4).

International Bankruptcies

The protection provided under U.S. Bankruptcy Code Section 365 may not be available in the event the main bankruptcy case is filed abroad. The case *In re: Qimonda AG*, Case No. 09-14766-RGM (Chapter 15) (Bankr. E.D. Va., Nov. 19, 2009) illustrates the potential problem. In *Qimonda*, the debtor commenced an insolvency proceeding in Germany. The debtor's authorized representative filed a petition with the U.S. Bankruptcy Court to recognize the German proceeding under Chapter 15 of the U.S. Bankruptcy Code – which the U.S. Bankruptcy Court granted. As a result of this recognition, the U.S. bankruptcy court enjoyed jurisdiction over Qimonda's U.S. assets. The U.S. Bankruptcy Court also entered a supplemental order providing, among other things, that U.S. Bankruptcy Code Section 365 would be applicable to the Chapter 15 proceeding.

The debtor's foreign representative then requested that the U.S. Bankruptcy Court modify its previous order to exclude applicability of U.S. Bankruptcy Code Section 365 on the



grounds that Section 365 substantially undermines the provisions of the German Insolvency Code. The parties argued that the treatment of executory contracts under U.S. Bankruptcy Code Section 365 and the German Insolvency Code differs. Under the U.S. Bankruptcy Code, the trustee may reject an executory contract but the counter-parties may retain certain rights in the executory contracts. Under the German Insolvency Code, the administrator of the insolvency proceeding may elect non-performance of executory contracts. The non-debtor licensees of intellectual property in *Qimonda* argued that the foreign administrator may take the position under the German Insolvency Code that he may terminate an intellectual property license and then submit the license for sale on the open market by exercising his right of non-performance.

The U.S. Bankruptcy Court granted the motion of the debtor's foreign representative and modified the previous order to exclude applicability of Bankruptcy Code Section 365 to the Chapter 15 proceeding. The U.S. Bankruptcy Court reasoned that the principal purpose of Chapter 15 of the U.S. Bankruptcy Code is that the bankruptcy proceeding be governed in accordance with the bankruptcy laws of the nation in which the main case is pending and that ancillary proceedings such as a Chapter 15 proceeding should supplement, but not supplant the foreign proceeding.

Risks Associated with Bankruptcy Sales.

It is imperative for licensees and their counsel to monitor actively bankruptcy cases and be vigilant in the event of a proposed Bankruptcy Code Section 363(f) sale of the debtor-licensor's intellectual property – because such sale may affect their licenses. Bankruptcy Code Section 363(f) permits a trustee or debtor-in-possession, to sell property “free and clear” of a non-debtor's interest in such property, if certain conditions enumerated in that statute are met and upon notice to creditors. In *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC*, 327 F.3d 537 (7th Cir. 2003), the Seventh Circuit held that an order issued pursuant to section 363(f)



had the effect of extinguishing the possessory rights of a real property lessee, notwithstanding the failure of the debtor to reject the lease formally under section 365(a). Notably, in arriving at its decision, the Seventh Circuit found no conflict between section 363(f) and section 365(h), which permits a real property lessee to retain its possessory rights in the property notwithstanding the debtor's rejection of the underlying lease. Pursuant to the *Qualitech* decision, a real property lessee who wishes to retain its possessory rights cannot rely solely on its election under section 365(h) following rejection of its lease, but rather must affirmatively object to a section 363(f) sale of the underlying assets or, alternatively, must file a request for "adequate protection" of its interest pursuant to Bankruptcy Code Section 363(e). Since section 365(n) provides an election for IP licensees that is similar to the election for real property lessees under section 365(h), *Qualitech* could be extended to allow the extinguishment of IP licenses without giving licensees an opportunity to exercise their section 365(n) election. See also *FutureSource, LLC v. Reuters Ltd.*, 312 F.3d 281, 285 (7th Cir. 2002) (holding that Bankruptcy Code Section 363(f) sale order extinguished all interests in the assets, including license in intellectual property).

Bankrupt Debtor-Licensee.

It should be noted that the Intellectual Property Bankruptcy Protection Act does not address the situation of a bankrupt licensee. A debtor-licensee of intellectual property may reject an executory contract and return the licensed intellectual property to the licensor. Below we discuss issues related to a debtor-licensee's ability to assume a license when the licensor does not consent.

Strategies Based on Specific Section 365(n) Cases.

Avoiding Application of Foreign Governing Law and Liquidated Damages

The court in *In re El International*, 123 B.R. 64 (Bankr. Idaho 1991) was the first to apply the 1988 Intellectual Property Bankruptcy Protection Act amendments. The ruling demonstrates



how Section 365(n) may be used to avoid the application of foreign law under a governing law provision in the executory contract and to avoid the imposition of liquidated damages or other damages.

In *El International*, the debtor entered into a pre-petition agreement with a Canadian public utility corporation to supply a software system, as customized to meet the public utility's requirements. The debtor rejected that executory contract post-petition pursuant to U.S. Bankruptcy Code Section 365. The public utility claimed \$3.6 million in contract damages, most of which was to correct deficiencies and omissions to make good the delivered software. The debtor acknowledged allowance of only about 5% of the public utility's claim.

Despite the contractual governing law clause that required application of Ontario law, the U.S. Bankruptcy court held that U.S. bankruptcy law governed the dispute in the bankruptcy court. As such, Section 365(n) may be viewed as a strategy for avoiding the application of foreign law under limited circumstances.

The *El International* court also concluded that the public utility's claim should be treated like any other claim arising from a rejected executory contract under Section 365. When an executory contract is rejected under Section 365, the entire contract is rejected, including the damage provisions. The court held that the contractual liquidated damage provision was not enforceable because "if liquidated damage clauses were enforceable, there would be no reason for rejection of the contract by a debtor." The court found that since the public utility elected to retain the software, rather than treat the contract rejection as a termination, the public utility was deemed to waive any right of set-off and any post-petition contract claims. The court ruled that the public utility was entitled only to the damages it would have sustained as a pre-petition claim for breach of the contract by the debtor. The public utility's allowable claim was thus limited to its actual, pre-petition "out of pocket costs" incurred by the public. Accordingly, Section 365(n) can also be used as a strategy for limiting damages and remedial obligations. This strategy, for



example, could be useful in connection with a failed software development project where the licensor is facing significant potential money damages and performance obligations.

Section 365(n) Can Be Used By Licensors as a Collection Strategy.

Although the decision in *Encino Business Mgmt. v. Prize Frize, Inc.*, 32 F.3d 426 (9th Cir. 1994) does not involve information technology, it is a very important bankruptcy ruling on whether license fees paid by a licensee for the use of technology, patents and proprietary rights are “royalties” within the meaning of Bankruptcy Code § 365(n)(2)(B) and, as such, must continue to be paid after the debtor-licensor rejects the executory contract.

In *Prize Frize*, under a pre-petition license, the licensee agreed to pay the licensor a license fee of \$1,250,000 which was to be paid as follows: \$300,000 at execution and then \$50,000 per month for 19 months. The licensor filed a Chapter 11 bankruptcy petition and the licensee stopped making the monthly license fee payments because of a design defect in the technology. The debtor-licensor filed a motion to reject the license agreement and to compel the licensee to elect whether it wished to retain its rights under Section 365(n)(1). The bankruptcy court ordered that, in the event the licensee elected to retain its rights under the license pursuant to Section 365(n)(1), it must pay all license fees presently due, pay the balance in monthly installments and waive any and all set-off rights under non-bankruptcy law and any administrative priority claim under Bankruptcy Code Section 503(b) based on performance of the agreement.

The *Prize Frize* court held that, when the licensee elected to retain its rights to the license under Section 365(n), the licensee was obligated to make *all* royalty payments due under the contract. The bankruptcy court rejected the licensee’s argument that the license agreement distinguished between royalties and license payments and that the license fees are not royalty payments that must be paid in the event of retention. The bankruptcy court noted that 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 were “licensing fees” or “royalties” and, as royalties, must be paid by the licensee who elects to keep its license pursuant to Section 365(n). The court raised the question of whether an allocation would have been proper in view of licensor’s other contract obligations for which it was no longer responsible; however, the issue was not raised by the parties and therefore not considered in the ruling.

The *Prize Frize* case suggests how Section 365(n) may be used to collect license fees and royalties. For example, assume that the licensor is a very small company or otherwise unable to fund a legal collection lawsuit. The licensee asserts grounds, whether real or just a pretense, for not paying licensor license fees that are otherwise due. Licensee knows that licensor is experiencing financial problems and does not have the wherewithal to commence a collection lawsuit against licensee. Licensor can use Section 365(n) and the bankruptcy court to collect licensee’s debt to licensor to the extent licensee elects to retain the licensed intellectual property.

Royalty payments are not defined in the Bankruptcy Code, but the legislative history and the *Prize Frize* ruling suggest that whether a payment is a “royalty” depends on the substance of the transaction and not the label. Because of this ambiguity, we recommend contract provisions that specify the royalty payments in the event of a Section 365(n) election.

Section 365(n) Can Affect the Timing and Strategy for Acquiring IP Assets in a Bankruptcy Proceeding

The ruling in *Schlumberger Resource Management Services, Inc. v. CellNet Data Systems, Inc.*, 327 F.3d 242 (3rd Cir. 2003), provides a number of valuable lessons regarding the purchase of intellectual property assets in a bankruptcy proceeding, including any license agreements relating to the intellectual property assets.



In *CellNet*, pursuant to a pre-petition license agreement, the debtor-licensor received from licensee a royalty equal to three percent of licensee's gross revenues from the licensed technology. Pursuant to Bankruptcy Code Section 363, the debtor post-petition sold to a third party purchaser its intellectual property assets, including the technology that was the subject of the above license. The sale agreement provided for the purchase of the intellectual property assets but excluded the subject license. This purchase effectively severed the license agreements from the intellectual property assets sold. Following the third party's purchase, the debtor rejected the subject license agreement pursuant to Bankruptcy Code Section 365.

After the debtor rejected the subject license agreement, the licensee elected to retain its rights under Section 365(n). Under Section 365(n), the licensee is required to make all royalty payments due under the contract for the duration of the contract. By its election under Section 365(n), the licensee was permitted to continue using the licensed intellectual property originally licensed from the debtor but was required to pay the royalties due under the license agreement. Even though the third party acquired the debtor's intellectual property assets in the bankruptcy proceeding, the third party was not entitled to the royalties arising from the subject license because such license was excluded from the assets purchased from the debtor. The licensee was required to pay the royalties to the debtor rather than the third party purchaser despite the purchaser's ownership of the underlying intellectual property assets.

It appears that neither the third party purchaser nor the debtor fully appreciated the potential risk that licensee might elect to retain the licensed technology under Section 365(n) under the rejected license agreement. This result speaks to the need for careful analysis of the risks of Section 365(n). For example, it may have been more prudent to acquire the license agreements as part of the acquisition in the bankruptcy proceeding then terminate the license agreements after the acquisition closed, to the extent the agreement permitted such termination. This may not have been possible but it is the type of analysis that would need to be conducted.



Must Recognize That Trademark Rights are not Covered by Section 365(n)

The bankruptcy court in *In re Centura Software Corporation*, 281 B.R. 660 (Bankr. N.D. Cal. 2002), granted the debtor's and creditors committee's motion for partial summary judgment on the grounds that Bankruptcy Code Section 365(n) does not protect the licensee's rights to use the debtor's trademarks. The bankruptcy court concluded that once a license has been rejected the counter-party may not continue to use the trademarks.

In *Centura*, a licensee sought to continue to market and sell software products under trademarks owned by the debtor and sought software updates and documentation. Under Section 365, if a contract is rejected the debtor is deemed to have breached it, and the bankruptcy estate loses any benefit from the contract. The licensee elected to retain its rights under Bankruptcy Code Section 365(n) to market and sell the software, however, the court held that, because Section 365(n) does not extend to trademarks, the licensee is left with a Section 365(g) claim for damages resulting from being unable to use the trademarks in its business. The court determined that Congress unambiguously indicated that trademark licenses are excluded from Section 365(n) by omitting trademarks from the definition of "Intellectual Property" under the Bankruptcy Code. The licensee lost its trademark rights but was entitled to file an unsecured pre-petition claim for damages resulting from its inability to use such trademarks. The court also denied licensee any post-petition performance respecting enhancements because the debtor had no obligation to support the licensee after licensee elected to retain the license under Section 365(n).

The fact that Section 365(n) does not include trademarks may prove extremely important. For example, assume that your client has an exclusive trademark license that is critical to your client's business plans. The licensor experiences significant financial difficulties. Four petitioners file an involuntary bankruptcy petition against the licensor. If the involuntary bankruptcy proceeding goes forward, there is a significant risk that the licensor will reject the



exclusive license and the licensee will lose its trademark rights notwithstanding already paying the licensor millions of dollars for such rights. Under these circumstances the licensee is likely to determine it is compelled to acquire the trademark rights from the licensor. The purchase price may be based on the amount necessary to satisfy the licensor's creditors to avoid any liens being filed against the trademark assets and otherwise have the involuntary bankruptcy proceeding against the licensor dismissed. Section 365(n) can require strategies like this to be implemented.

Strategy Recommendation: Royalty Clauses.

The parties to a license may want to adjust the payment terms to reflect the responsibilities of the parties in the event the licensee elects to retain the licensed software and related source code. Typically, license fees, renewal fees, maintenance fees and so forth, implicitly include royalties for the use of the licensed intellectual property but the royalties are not expressly denominated as such. Licensors need to ensure a continuing revenue stream from the retaining licensee. We recommend that license agreements contain a royalty payment clause that contemplates a situation where licensee is granted the right to retain the licensed software albeit without any licensor support. If maintenance is not provided by the licensor, then there would probably be no continuing obligation to pay the licensor for the retained use of the software and related source code if the licensee's only existing obligation, for example, was to pay maintenance fees.

Below is an example of this type of provision:

If the Licensor rejects the License Agreement under Section 365(n) of the Bankruptcy Code, the Licensee may elect to (i) treat the Agreement as terminated pursuant to Section XXX (Termination) of this License Agreement, in which case Licensee shall have a claim for damages against Licensor equal to \$ _____, or (ii) retain Licensee's rights under the License Agreement, including, without limitation, the right and license to use, adapt and modify the Licensed Software and related Source Code for the full term of the License Agreement and obtain a complete and current copy of the source code corresponding to the licensed software used by Licensee from the Source Code



Escrow Agent or, in the event a complete and current copy of the Source Code is not provided to the Source Code Escrow Agent, then directly from Licensor.

In consideration of obtaining a copy of the Source Code under the provisions of this Agreement, Licensee agrees to pay Licensor, in lieu of any other fees, an annual royalty in the amount of \$_____ commencing upon Licensor's receipt of the Source Code and continually thereafter on the anniversary of such receipt for as long as Licensee continues to use the Licensed Software, or any derivative thereof.

The royalty payment will differ from situation to situation. If the licensor is not providing any maintenance and support, we suggest that the royalty should be substantially less than 50% of what would otherwise have been the licensee's annual maintenance fee obligation. An annual royalty of between 10% and 20% of the annual maintenance fee obligation is likely to be reasonable in most circumstances.

Strategy Recommendation: Source Code Escrow.

Description.

A source code escrow is an arrangement by which the licensor places source code in the hands of an independent third party for safekeeping. Then, in the event of the occurrence of any one of a number of enumerated events, such as the licensor's business cessation or discontinuance of support for a product line, the licensee is entitled to receive a copy of the source code. The user should seek to ensure that the source code and all other information the user will need to maintain the software itself are deposited into escrow.

The purpose of source code escrow arrangements is to have a current and complete copy of the source code corresponding to the licensed software held in safe-keeping for the benefit of the licensee in the event the licensor ceases business operations or is no longer able to maintain and support the licensed software. The source code escrow arrangements should be designed to permit the licensee to take over the licensor's support obligations.

Interplay with Bankruptcy Code Section 365(n).



License provisions that require delivery of source code, technical documentation, or other intellectual property in the event of the licensor's bankruptcy are enforceable under Bankruptcy Code Section 365(n)(3). Thus, even if the license agreement provides for source code delivery after bankruptcy, the licensee can require the source code to be delivered to it. If the source code was not delivered, the licensee should be able to enforce those "delivery rights" by filing a motion with the Bankruptcy Court. An example of a Source Code Escrow is Exhibit C. The material escrowed can include intellectual property and upgrades and modifications. It is not clear whether relief from the automatic stay is required to access the escrowed material. The safe way to proceed is to assume that relief should be sought; in the right circumstances relief can be sought on shortened time.

Source Code Risk.

It should be emphasized that source code escrow arrangements carry some definite risks. For complex systems, even with source code access, there are definite concerns that software maintenance may prove to be commercially impractical because the coding may be too difficult to comprehend in a reasonable amount of time. Assessing the source code risk may require a review of the code along with other considerations.

If the program code is not understandable and well-documented, you may consider other strategies to improve the likelihood that you will be able to maintain the code. One strategy is to require that the licensor prepare a tutorial video where the programmers would "walk" the licensee through the code so that the program code is understandable.¹⁰ Likewise, in addition to the source code, technical documentation that will aid in understanding the program code should be stored. During contract negotiations you should seek to make sure everything the

¹⁰ In a technology transfer agreement related to a source code license, it is fairly common to include a consulting services component to familiarize the licensee with the source code. The video tutorial may serve that purpose.



licensee will need to assume software maintenance and support is stored in escrow or otherwise provided.



Waiver of Prohibition Against Hiring.

Typically, the license agreement is likely to contain a prohibition against hiring licensor employees. Licensor's programmers are likely to be the most knowledgeable personnel concerning the program code. During negotiations the licensee should seek to identify the most knowledgeable programmers and expressly waive any prohibitions against hiring them in the event licensee is granted access to the source code.

Waiver of Prohibition Against Reverse Engineering.

Another contract provision to consider is the prohibition against decompilation, disassembly, translation or other reverse engineering. This type of prohibition against reverse engineering is included in most software licenses. It does not make any sense if the licensee obtains access to source code. Accordingly, we recommend that the prohibition be waived and the licensee be granted an express right to decompile, disassemble, translate and otherwise reverse engineer the licensed software in the event the licensee is granted access to source code. This may provide the licensee with added rights that may prove helpful. For example, if the source code provided is not current, this right may provide the licensee with the rights necessary to reverse engineer or otherwise derive the source code for changes not included in the delivered source code. By matching the software based on the delivered source code with the software the licensee is actually using, the licensee should be able to generate a listing of changes. This listing may be used to obtain current source code from the licensor or as a basis for reverse engineering the changes.

Section 117 Rights.

Another provision to consider relates to Section 117 of the Copyright Act which gives the owner of a copy of the copyrighted software the right to modify the software to the extent necessary to utilize the software and the right to copy the software for archival purposes. Most court rulings have held that licensees do not have the rights conferred under Section 117



because they are not owners of the copy of the software licensed to them. To the extent the licensee obtains source code we believe the licensee should be granted all of the rights under Section 117 with respect to the software and related source code licensed to licensee. These rights will further strengthen licensee's rights to modify and adapt the software in the event the licensee must take over maintenance and support of the licensed software.

Include a License for Future Interest.

We recommend including a current license to the source code corresponding to the licensed software, subject to a subsequent future condition based on the conditions for obtaining access to source code. This is in essence a license to use a future interest.¹¹ We recommend that this license to source code include the right to copy, adapt and modify the source code for licensee's internal use and support consistent with licensee's license agreement even though the rights are not triggered until the source code license commences. The future condition subsequent could be tied to obtaining access to the source code held for licensee's protection under a source code escrow arrangement or other event(s).

Sample Agreements.

We have attached sample agreements as Exhibits A, B C, and D. Exhibit A is a form Services Agreement. Exhibit B is a form software license agreement. Exhibit C is a form source code escrow agreement. Exhibit D is a form IP Security Agreement. To the extent possible, these agreements and their provisions should be segregated, so as to avoid an argument that they are all part of one integrated agreement. If the licensee has a significant level of bargaining power, consider structuring the transaction whereby formal ownership of the IP is transferred to a "bankruptcy remote entity."

¹¹ See *DDB Techs., LLC v. MLB Advanced Media, LP*, No. 2007-1211, 2008 US App. LEXIS 11180 (Fed. Cir. Apr. 14, 2008) (discussing licensing of future interests before the future interest occurs).



IV. RESTRICTIONS ON ASSUMING LICENSE AND THE BANKRUPT DEBTOR-LICENSEE

Although most executory contracts are assumable pursuant to Section 365(a), certain contracts are expressly made non-assumable by the Bankruptcy Code. Section 365(c)(1) provides that the trustee may not assume or assign any executory contract if applicable law excuses the non-debtor to such contract from accepting performance from an entity other than the Debtor. Thus, if non-bankruptcy law prohibits the assignment of a contract without the other party's permission (e.g., a personal services contract), and the other party is not found to have expressly or impliedly granted such permission, the Debtor may not be able to assume or assign it. Copyright licenses, for example, are not assignable without the written permission of the copyright holder.¹² Similarly, a non-exclusive patent license has been held to be personal and therefore subject to the Section 365(c)(1) restriction. See *In re CFLC*, 89 F.3d at 677.

There is currently a split in the circuits on how broadly Section 365(c)(1) is interpreted. In the Ninth, Third, Fourth, and Eleventh Circuits, courts interpret the statute to prohibit both assumption and assignment of the executory contract. See, e.g., *In re Catapult Entertainment, Inc.*, 165 F.3d 747, 750 (9th Cir. 1999), *cert. dismissed*, 120 S. Ct. 369 (1999) (holding that non-exclusive license to a patent was non-assumable by the debtor-in-possession.); *In re Sunterra Corporation (RCI Technology Corp. v. Sunterra Corp.)*, 361 F.3d 257 (4th Cir. 2004) (same with respect to software license. *But see, e.g., Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1996), *cert. denied*, 521 U.S. 1120 (1997); *In re GP Express Airlines, Inc.*, 200 B.R. 222, 231-33 (Bankr. D. Neb. 1996) (holding that debtor may assume a patent or copyright license, but may not assign it to a third party). Non-exclusive copyright licenses, like

¹² The rule was recently stressed in *Cincom Systems, Inc. v. Novelis Corp.*, 581 F.3d 431, 437 (6th Cir. 2009). In the *Cincom* case, the Sixth Circuit discussed the general rule regarding assignability in the context of intellectual property. In particular, the Sixth Circuit noted that intellectual property licenses are presumed to be nonassignable and nontransferable in the absence of "express provisions to the contrary." Where the license agreement is silent on its assignability the license agreement must be construed consistent with Federal copyright law and policy prohibiting unauthorized transfers in the absence of express authorization.



non-exclusive patent licenses discussed above, are not freely assignable by debtors unless the copyright licensor consents. However, like patents, it is less clear whether an exclusive copyright license is assignable.¹³ In *Gardner v. Nike, Inc.*, 279 F.3d 774 (9th Cir. 2002), the Ninth Circuit applied the rule of nonassignability to an exclusive license.¹⁴

The non-assumption risk should be manageable by a contract provision.¹⁵ Below is a simple provision dealing with the non-assumption risk.

Assumption. Notwithstanding any provision to the contrary, in the event Licensee declares bankruptcy and elects to assume this License Agreement in the bankruptcy proceeding, Licensor hereby consents to such assumption by Licensee provided Licensee agrees to comply with all of the terms and conditions of the License Agreement.

This provision starts with the proverbial “notwithstanding any provision to the contrary” because most license agreements provide for termination in the event of bankruptcy even though such provisions are *ipso facto* invalid and unenforceable pursuant to Section 365(e) of the Bankruptcy Code.¹⁶ The licensor’s consent to an assumption only occurs if the licensee makes the decision to assume the license. The provision does not obligate the licensee to assume the license.

V. SUPPORTING A TROUBLED LICENSOR

Reasons to advance payment or lend money to a troubled lender.

Occasionally a licensee will be willing to accelerate its payments by providing a loan to the licensor in order to try to avoid the problems created by bankruptcy. This strategy is an

¹³ See *In re: Golden Books*, 269 B.R. 300 (Bankr. D. Del. 2001);

¹⁴ In the *Gardner* case, the Ninth Circuit determined that under the Copyright Act, the licensee has the burden of obtaining the licensor’s consent before it may assign its rights, absent explicit contractual language to the contrary. Moreover, the Ninth Circuit observed even if the licensee had the right to transfer the license under the applicable state law, the interpretation of state law must bow to federal law because the interpretation interferes with Federal Copyright law and policy.

¹⁵ It is noted that this strategy does not run afoul of the rule that a debtor cannot unilaterally contract away its authority to assume or reject an executory contract. See *In re: TWA*, No. 01-0056, 2001 Bankr. LEXIS 267 (Bankr. Ct. D. Del. Mar. 12, 2001).

¹⁶ See *In re: Computer Commons, Inc.*, 824 F.2d 725 (9th Cir. 1987).



opportunity to adjust terms of the license to avoid some of the concerns described. Some of the reasons a company would be willing to undertake this additional risk are:

The cost of finding an alternative source to complete the work.

Often the cost in both lost time and development if the licensor fails is greater than any possible claim that might be made in a bankruptcy estate. This can be even more pressing if the grant of license to the buyer is conditioned on the completion of the work.

Preserving the intellectual power of the relationship.

Often the parties have created an effective relationship over several months of working together, and the knowledge level and skill of the troubled company's employees would be difficult to replace.

Taking A Security Interest in the IP to Protect the Additional Risk.

If the licensee has leverage such that it can get a security interest in the intellectual property to secure the Debtor's performance under the license, such a security interest gives rise to secured claims, which should be a disincentive to any rejection. See Exhibit D - Sample IP Security Agreement.

Traditionally, security interests are given to secure the payment of money. A licensee can also take a security interest to secure the completion of work. California's commercial code states that a '[s]ecurity interest' means an interest in personal property...which secures payment *or performance of an obligation.*" Cal. Com. Code § 1201(b)(35) (emphasis added).

Adjusting contract terms.

If the cost to the licensee resulting from the license not being implemented is greater than the initial license fees, this limit should be adjusted. The parties could also agree to a sum for liquidated damages to cover the cost of the delay to the licensor if the project fails; these damages should then be covered by the security interest. The timing of the transfer of rights in licensed technology should also be changed to address the problems discussed above. All of



these changes must be analyzed for the risks of preference and fraudulent conveyance claims in bankruptcy, and the risk of an unenforceable penalty clause. One way to address such threats is to set out in recitals to the new agreement that the loan (or acceleration of payment) is made primarily to benefit the licensor, that the licensor cannot find adequate funding elsewhere, and that without the loan the licensor is likely to fail. This will support an argument that the Debtor is making a reasonable bargain. Recitals of fact are generally persuasive evidence. “The facts recited in a written instrument are conclusively presumed to be true as between the parties thereto.” Cal. Evid. Code § 622. Of course, if the licensor is in bankruptcy within 90 days of the buyer perfecting its security interest, the agreement may be set aside. Bankruptcy Code § 547.

VI. PERFECTING A SECURITY INTEREST IN INTELLECTUAL PROPERTY.

Perfecting a security interest is essential.

It is essential to perfect a security interest to prevent a trustee in bankruptcy from avoiding the security interest as a “hypothetical lien creditor” under Bankruptcy Code § 544.

Perfecting a security interest in copyrighted material.

To perfect a security interest in a *registered* copyright, record the security interest with the Copyright Office. *In re Peregrine Entm’t, Ltd.*, 116 B.R. 194 (Bankr. C.D. Cal. 1990); *In re AEG Acquisition Corp.*, 127 B.R. 34 (Bankr. C.D. Cal. 1991). Because of the recent trend of cases, also record a UCC-1 financing statement in the debtor’s state of operation and its state of incorporation. See *In re Cybernetic Servs, Inc.*, 252 F.3d 1039 (9th Cir. 2001). Note that a relatively recent Ninth Circuit case held that a security interest in an *unregistered* copyright is perfected through the filing of a UCC-1 financing statement. *Aerocon Eng’g v. Silicon Valley Bank*, 303 F.3d 1120 (9th Cir. 2002). Additionally, if a copyright is not registered currently the secured creditor can require that the borrower register it so that the security interest may be recorded in the Copyright Office. *In re Avalon Software Inc.*, 209 B.R. 517 (Bankr. D. Ariz.



1997). This may be impractical in a license development context, as the work is in the process of being created. Requiring registration would also raise issues about confidentiality.

Scope of Perfected Security Interest in Registered Copyrights

In *In re Avalon Software, Inc.*, 209 B.R. 517 (Bankr. D. Az. 1997)(overruled, on other grounds, by *In re World Auxiliary Power Co.*, 303 F.3d 1120, 1130 (9th Cir. 2002)), the lender filed a UCC-1 financing statement with the Arizona Secretary of State's Office but failed to record its financing statement, security agreement, or any other document evidencing its security interest with the U.S. Copyright Office. The court held that the proper method to perfect security interest in copyrights is by recordation with the United States Copyright Office. The court held that, because the lender failed to do so, it did not have a perfected security interest in any of the debtor's software, modified software, licenses, manuals or agreements relating to the distribution of the software and proceeds therefrom. However, the court determined that the debtor's maintenance, consulting and serving agreements did not significantly include the sale or licensing of any tangible "intellectual property" and, as such, were subject to the lender's perfected security interest.

Third Party Software Modifications Not Covered By Security Interest

In *In re CTek Software, Inc.*, 127 B.R. 501 (Bankr. D.N.H. 1991), a secured creditor perfected a security interest in a debtor's computer software that covered "the source code and all ownership rights to the computer software ClientTrak including copyrights 1983, 1984, 1985, 1986 and 1987." After granting the foregoing security interest, the debtor entered into a worldwide license for the right to sell and develop that software. In consideration of the distribution license, the distributor agreed to pay the debtor royalties which would decrease in amount over time as the distributor made changes to the software. In particular, the debtor gave the distributor the right "to produce, copy, distribute and market derivative versions of the



software and documentation without limitation.” However, the distributor’s modified version of the software was not subject to the security interest held by the secured creditor. In the software industry, a distribution agreement like this one effectively transfers the technology from the licensor to the distributor licensee. The secured lender made a significant mistake by failing to ensure that its security interest applied to the improved software.

The *CTek* court considered the extent of the secured creditor’s security interest in the source code in light of the distributor’s software modifications after the secured creditor’s security interest was perfected. The court relied on *Stewart v. Abend*, 495 U.S. 297 (1990), declaring that: “the aspects of a derivative work added by the derivative author are the author’s property, but the element drawn from the pre-existing work remains on grant from the owner of the pre-existing work.” The court also observed that “[w]orks substantially derived from prior works, whether pre-existing works are copyrighted or in the public domain, are also subject to copyright protection so long as the derivative work itself is original.” The Bankruptcy Court believed that “bug” fixes can have sufficient originality to be independently created copyrightable subject matter, i.e., that they are not “trivial” in a copyright sense. The court determined that the software modifications made by the distributor’s programmers required independent effort and judgment. In fact, the Bankruptcy Court, relying on expert proof, noting that “it is more difficult to modify another programmer’s source code than to create one’s own.”

The Court ruled that the security interest did not cover the distributor’s software modifications because the software version that is subject to the security interest can be severed from the derivative work version of the software. Therefore, by virtue of being able to sever the modifications from the current version (presumably by simply referring to an archival copy of the original software) the distributor was able to overcome the doctrine of accession. The Bankruptcy Court further ruled that the distributor has a license from the debtor to copyright derivative software, the software modifications met the originality requirements of the copyright



laws, and the distributor owned those software changes free and clear of any lien from the secured creditor.

As a result, the security interest held by the creditor was greatly devalued because it did not apply to the enhanced software – it only applied to the older version which had become technologically obsolescent.

Perfecting a security interest in a patent.

To perfect a security interest in an issued patent, record a UCC-1 in the state of operation and the state of incorporation. *In re Cybernetic*, 252 F.3d at 1058 (Ninth Circuit held that neither 35 U.S.C. § 261 of the Patent Act nor Article 9 of the UCC, as adopted in California, requires the holder of a security interest in a patent to record it with the PTO to perfect the interest as against a subsequent lien creditor.)

Perfecting a security interest in a trademark.

To perfect a security interest in a registered trademark, record a UCC-1 in the state of operation and state of incorporation. (However, it is advisable to also be recorded with the PTO as protection against subsequent bona fide purchasers/lien creditors of underlying collateral).

Enforcing the Security Interests.

Relief from stay.

A creditor of a debtor must obtain relief from a stay to foreclose on its security interest. After relief is obtained, the creditor must comply with the rules of Article 9 of the Uniform Commercial Code regarding the disposition of collateral by a creditor after default.

Sale of collateral.

The primary tool for foreclosing on a security interest is for the creditor to sell the collateral at a public or private foreclosure. Article 9 requires specific notice of the sale. It also requires that the sale be conducted in a commercially reasonable manner. Cal. Com. Code § 9610(b). In most cases of a partly-developed product, the creditor in a license development



relationship would want to avoid a noticed public sale, as it would disclose the developing product to the public (including any competitor). Also, it would be difficult to meet the “commercial reasonableness” requirements for the sale of an incomplete license.

Taking possession and ownership in satisfaction of a claim.

UCC Section 9620 sets out the rules for a creditor to take possession and ownership of collateral in satisfaction of the debt. In order for a creditor to acquire the collateral as only partial satisfaction of the debt, the Debtor must agree to this form of foreclosure after the default. (The Debtor cannot waive this right beforehand.) If acquisition is in full satisfaction of the debt, the creditor must follow certain conditions including notice rules, but does not have to obtain permission of the Debtor unless the Debtor objects. In a development context, the collateral may be unfinished work-product, which is of real value only to the creditor/licensee or its competitors. By having the status of a secured creditor (assuming the claim is valid and cannot be set aside as a preference or fraudulent transfer), the creditor can foreclose on its security interest by acquiring the collateral in satisfaction of the claim and get possession of the work without having to pay a bankruptcy trustee. This also prevents its exposure to competitors.

VII. DISCHARGEABILITY OF COPYRIGHT JUDGMENTS IN A BANKRUPTCY PROCEEDING

Section 523(a)(6) of the Bankruptcy Code provides that an individual debtor may not discharge a debt “for willful and malicious injury by the debtor to another entity or to the property of another entity.”¹⁷ Bankruptcy courts analyze both the issue of “willfulness” and “maliciousness” to determine whether debtor may discharge a particular debt under Section 523(a)(6). A “willful” injury under Section 523(a)(6) is defined as a “deliberate or intentional

¹⁷ See *In re Barboza*, 545 F.3d 702 (9th Cir. 2009).



injury, not merely a deliberate or intentional act that leads to injury.”¹⁸ For an injury to meet the definition of “malicious” it must meet a four-part test. There must be: (1) a wrongful act, (2) done intentionally, (3) which necessarily causes injury, and (4) is done without just cause or excuse. In the event the copyright owner (or other IP owner) cannot establish both the necessary “willfulness” and “maliciousness” the infringing debtor should be able to discharge the liability on the infringement judgment through bankruptcy.

The dischargeability standard in bankruptcy under Section 523(a)(6) does not correspond with the liability standards for determining willful patent infringement, copyright infringement or trademark infringement. A finding of willful copyright or other IP infringement will not necessarily provide a basis for establishing either the “willful” or “malicious” elements under the Bankruptcy Code. The legal standards are different.

The potential problem is demonstrated by the Ninth Circuit’s recent ruling in *In re Barboza*, 545 F.3d 702 (9th Cir. 2009). In the *Barboza* case the Ninth Circuit reversed the Bankruptcy Appellate Panel by holding that a judgment for willful copyright infringement was nondischargeable under the Bankruptcy Code, even though the jury had returned a verdict of willful copyright infringement. Notwithstanding the verdict, the jury made no specific findings as to its basis for finding willful copyright infringement.

In the *Barboza* case the Ninth Circuit found that the standard for “willfulness” under Section 523(a)(6) of the Bankruptcy Code requires a “deliberate” or “intentional” injury. The Ninth Circuit determined that the bankruptcy court had no way to determine whether the jury had found willful infringement based on a reckless disregard or a knowing violation of the copyright. The Ninth Circuit also found that the bankruptcy court had erred when it failed to

¹⁸ See *In re Seagate Tech.*, 497 F.3d 1360, 1371 (Fed. Cir. 2007).



examine separately whether the copyright infringement was malicious under Section 523(a)(6). The “willfulness” and “malicious” elements must be proven separately.

IP owners with willful patent infringement¹⁹ and willful trademark infringement judgments face similar obstacles to avoid dischargeability in bankruptcy. The evidence presented and jury instructions should be presented with the requirements for showing “willfulness” and “maliciousness” under the Bankruptcy Code. If these requirements are not met IP owners risk losing any IP infringement judgments they may have received in a subsequent bankruptcy proceeding.

VIII. CONCLUSION

The risks relating to bankruptcy need to be fully considered in copyright and other technology transactions. In this article, we have outlined a number of those risks and potential strategies to minimize those risks.

¹⁹ See *N.A.S. Import Corp. v. Chenson Enters, Inc.*, 968 F.2d 250, 252 (2d Cir. 1992).