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Addressing Bankruptcy and Credit Risks in Complex Intellectual Property and Technology Transactions

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It is a truism that business thrives on stability and predictability.[1] It is also clear that the acquisition and licensing of technology and other intellectual property transactions have become key components of a company's success.[2] Unfortunately for a business entering into important intellectual property and technology transactions, the prospect of bankruptcy can surround the transaction with long term uncertainty. Rights can be terminated, access to technology and intellectual property lost, and licenses transferred to competitors or other unforeseen or undesired third parties due to a bankruptcy or credit default. Only through careful planning at the outset of contract negotiations can a company reduce the potential for long-term problems.

These transactions can range from a simple patent assignment for cash, with no ongoing obligations on either side, to complex multi-party outsourcing or service agreements. At almost every point along this spectrum, the failure to account for bankruptcy and credit issues may frustrate the parties' expectations, with serious business consequences. This article will attempt to explain some of these issues, and suggest ways in which these unavoidable risks can be mitigated.

The Bankruptcy Process—An Overview

Automatic Stay

A general understanding of the bankruptcy process is required in order to understand the risks presented in technology transactions. With the filing of a bankruptcy petition, Section 362 of the Bankruptcy Code (Code) imposes an automatic stay of most actions against the bankrupt party (debtor) that might otherwise be available with respect to claims, events, or defaults that occurred prior to the institution of the bankruptcy case.[3] The automatic stay generally prevents counterparties to contracts with the debtor from utilizing any self-help remedies built into their contract, and prevents most legal action during the pendency of the bankruptcy case.[4]

Trustee and Debtor in Possession

Generally, in a Chapter 11 reorganization,[5] management continues to operate the business as a debtor in possession. Section 1107 of the Code grants a debtor in possession almost all of the rights, functions, and duties of a trustee.[6] This article will refer to a trustee and a debtor in possession interchangeably.

Avoidance of a Transfer

Licenses of intellectual property, in addition to outright assignments, are considered "transfers" under the Code. Transfers entered into prior to the commencement of a bankruptcy proceeding (including licenses of intellectual property) may, in certain circumstances, be set aside by the trustee. Under the "strong-arm" powers granted under Code Section 544, unperfected liens and unperfected transfers of property may be avoided.[7] Patent, trademark, and copyright assignments, exclusive copyright licenses (and possibly exclusive patent licenses[8]), security interests and liens that require registration, filing or recording may be vulnerable under Section 544 if the appropriate action for perfection has not been taken.

Even perfected transfers may still be vulnerable. In the event the transferee is a pre-existing creditor of the debtor, a transfer (whether of intellectual property or cash transferred in payment for intellectual property) can be voided as a preference under Code Section 547. Section 547 allows transfers to be set aside in the event such transfer: (1) is to or for the benefit of a creditor; (2) is on account of an antecedent obligation; (3) is made while the debtor is insolvent; (4) is made less than 90 days before bankruptcy (one year if the transferee is an insider); and (5) enables the transferee to receive a greater share of the bankruptcy estate than it would have received in a Chapter 7 liquidation.[9] Given the possibility that a license or sale of intellectual property may be set aside under Section 547, a party should be especially wary when entering into a transaction with a company that may file for bankruptcy if the transferee is a pre-existing creditor of the debtor.

In addition to the avoidance of preferential transfers under Code Section 547, transfers may be set aside as fraudulent under Code Section 548.[10] A transfer that was made within a year prior to the initiation of a bankruptcy case may be set aside if either: (1) the transfer was made with the intent to hinder, delay, or defraud a creditor of the transferor; or (2) regardless of intent, the transfer was made for less than reasonably equivalent value and the transferor was insolvent at the time of the transfer, or rendered insolvent by the transfer.[11] The potential for Section 548 set-aside renders "bargain" or "fire sale" purchases from, or other transactions with, a distressed company especially risky.

Section 365—Rejection, Assumption, and Assignment

Another potential pitfall for companies entering into technology and intellectual property transactions is the possibility of rejection or, conversely, assumption and assignment of the contract in bankruptcy. Section 365(a) of the Code allows the trustee in a bankruptcy case to assume or reject an executory contract in its entirety, subject to court approval.[12] Although "executory contract" is not defined in the Code, the generally accepted definitions render most technology and intellectual property transactions "executory."[13] The Countryman definition, set forth in a law review article by Professor Countryman, is the most frequently cited definition of an executory contract.[14] Under the Countryman definition, a contract is considered executory if the obligations of both parties are so far unperformed that a failure by either party to perform would constitute a material breach.[15] An alternate view adopted by some courts is the "functional" approach under which the court determines whether a contract is executory by considering the relationship between the parties to the contract, the goals of the reorganization and whether treating the contract as executory would benefit the estate of the debtor.[16]

The trustee's acceptance or rejection of a contract is subject to bankruptcy court approval. Most courts apply the business judgment rule in assessing the trustee's decision.[17] Under the business judgment rule, the court only considers whether the bankruptcy estate will benefit from the acceptance or rejection of the contract and therefore is likely to deny the trustee's election only where the trustee has acted in bad faith or with an extreme abuse of discretion.[18] Other courts apply the equitable standard in determining whether to grant the trustee's election to accept or reject a contract.[19] Under the equitable standard, the court weighs the benefit to the debtor against the detriment to the counterparty to the contract.[20]

Rejection

The rejection of a contract constitutes a pre-petition breach of the contract by the debtor.[21] While the non-debtor party to the contract is entitled to seek damages for such breach, the damages will be treated as an unsecured pre-petition claim and therefore is likely worth pennies on the dollar. In addition, the non-debtor party will have no right to seek specific performance of the contract by the debtor.[22]

Fortunately for licensees of intellectual property, Code Section 365(n) provides some protection in the event of a licensor's bankruptcy, though licensees of trademarks do not benefit from it.[23] Section 365(n) allows a licensee of intellectual property: (1) to treat the contract as terminated by virtue of the rejection, which would leave the licensee with an unsecured claim for damages as a result of the termination, worth, at best, pennies on the dollar; or (2) to retain its rights to intellectual property licensed under the license as they existed immediately prior to the commencement of the bankruptcy proceedings.[24] However, if a licensee elects the second option, it has no access to any maintenance, services or further improvements that may be included in the license.[25] In addition, the licensee is required to continue to make license payments for the relevant intellectual property.[26]

Assumption and Assignment

The trustee also may attempt to assume the contract and, in addition, to assign the assumed contract to a third party. In the event of an assumption of the contract, the contract continues in full force, subject to any requirement to cure any prior default and provide adequate assurance of future performance pursuant to Code Section 365(b).[27] Further, pursuant to Section 365(f) of Chapter 11, the trustee may then seek to assign the contract to a third party. Whether or not such assumption and/or assignment by a licensee of intellectual property is permitted in a particular situation is a matter of some disagreement in the relevant case law.[28]

Actual and Hypothetical Tests

Depending on where a Chapter 11 case is filed, a debtor-licensee of intellectual property may be prevented from assuming the license by Code Section 365(c)(1)(A), which provides that an executory contract cannot be "assumed or assigned" under Section 365 without the licensor's consent if "applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract . . . prohibits or restricts assignment of rights or delegation of duties."[29] The Third and Ninth Circuits, applying what is known as the hypothetical test, have held that a debtor in possession may not assume an agreement where applicable non-bankruptcy law prohibits assignment without consent, even if the debtor in possession has no intention of ever assigning the license.[30] It is known as the hypothetical test, since assignment is not actually being contemplated. The Eleventh Circuit has also adopted the hypothetical test, though outside of the context of a license of intellectual property.[31] The Court of Appeals for the First Circuit and at least one District Court within the Sixth Circuit have rejected the hypothetical test and allowed a debtor in possession to assume an executory contract, even if applicable non-bankruptcy law prohibited its eventual assignment.[32] In addition, at least one District Court in the Second Circuit appears to have adopted this "actual test."[33] Although this case was cast as a motion to cancel a contract, rather than to prevent its assumption, the court's discussion and holding are cast in terms of the assumption of the contract.[34]

Does Applicable Law Prevent Assignment?

Obviously, a key question in a case adjudicated under the hypothetical test (and under the actual test, if assignment is contemplated) is whether or not applicable law does, in fact, prevent assignment. The answer to this question varies based on the type of intellectual property licensed. Bankruptcy courts have held that nonexclusive licenses of patents and copyrights are not assignable in bankruptcy by licensees without express consent from the licensors, because assignment of these licenses is restricted by applicable non-bankruptcy law (federal patent and copyright law).[35] With respect to exclusive patent and copyright licenses, the state of the law is less clear.[36]

In the copyright arena, at least one case has held that the assignment of an exclusive copyright license is not prevented by applicable law,[37] while another has held that it is.[38] Each of these cases reaches its conclusion by analyzing the text of the 1976 Copyright Act, and each conclusion has some support therein. To assess risks facing parties in technology transactions, it is sufficient to note that whether an exclusive copyright license may be assigned remains uncertain. At least one court applying the hypothetical test has held patent licenses, whether exclusive or nonexclusive, to be assignable only with the consent of the licensor.[39] Case law addressing trademark licenses is in disarray.[40]

The only recent case to address assignability with respect to know-how licenses, *Verson Corp. v. Verson International Group*,[41] held that a nonexclusive know-how license is not assignable absent express consent from the licensor. The court reached this conclusion by reference to patent law, without discussion of why such law was controlling or persuasive.

Termination—The *Ipso Facto* Factor

Intellectual property licenses and technology service contracts frequently contain clauses giving a party the right to terminate the agreement on the bankruptcy or insolvency of the other. Section 365(e)(1) of the Code renders unenforceable any so-called *ipso facto* provision in an executory contract; *ipso facto* clauses provide for the termination or modification of the contract conditioned on the debtor's insolvency or financial condition, the commencement of bankruptcy proceedings or the appointment of a receiver or custodian.[42] Section 365(e)(1) provides:

> Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract . . . may not be terminated or modified . . . at any time after the commencement of the case solely because of a provision in such contract . . . 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.[43]

Section 365(e)(1) is commonly thought to render unenforceable *ipso facto* clauses in executory contracts. Another provision of the Code, however, calls this into doubt. Section 365(e)(2)(A) states:

> Paragraph (1) of this Section 365(e) does not apply to an executory contract or unexpired lease of the debtor, . . . if (i) applicable law excuses a party from accepting performance from or rendering performance to the trustee or to an assignee of such contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and (ii) such party does not consent to such assumption or assignment.[44]

This language implicates the same questions discussed above, as to whether applicable law prevents assignment in a given case. Should a party seek to terminate a contract based on Section 365(e)(2)(A), it should be noted that the automatic stay (discussed above) will still apply, and the party seeking termination shall have to petition the bankruptcy court for relief from the stay in order to terminate the agreement or enforce any other remedies against the debtor.

Security Interests

In addition to bankruptcy concerns, if an owner of intellectual property or technology has granted a security interest in such intellectual property or technology, and the security interest has been perfected, a licensee's or transferee's rights may be jeopardized. Under revised Article 9 of the Uniform Commercial Code (UCC), a licensee's or purchaser's interest is subject to any prior, perfected security interests, unless an exception applies. As technology companies frequently have secured debt, a default under the relevant credit or related agreement could result in the licensee losing rights in the technology as the secured party can foreclose on the asset, free and clear of existing licenses.

There is a notable exception contained within the UCC, however, that may be relevant to many technology and intellectual property transactions. Under Section 9-321, a licensee in the ordinary course of business is entitled to the benefit of a nonexclusive license free of a pre-existing, perfected security interest. The section defines a licensee in the ordinary course of business as "a person that becomes a licensee of a general intangible in good faith, without knowledge that the license violates the rights of another person in the general intangible, and in the ordinary course from a person in the business of licensing general intangibles of that kind." Section 9-321 goes on to state that a person becomes a licensee in the ordinary course if the license to the person comports with the usual or customary practices in the kind of business in which the licensor is engaged or with the licensor's own usual or customary business practices.

Dealing with Bankruptcy and Credit Issues

Having provided background regarding the bankruptcy process, we now turn to addressing these issues in the context of intellectual property and technology transactions. A number of steps may be taken to mitigate the wide range of potentially adverse bankruptcy and credit risks associated with contractual and business relationships. Of course, these will vary from transaction to transaction, depending on transaction type and the concerns of the parties. One constant, however, is that early consideration of bankruptcy and credit issues in the life cycle of a particular transaction better enables a company to undertake preventive or mitigating measures.

Technology Transferee

With respect to a transferee of technology, the key concern of the transferee is likely to be ensuring continued access to the technology. The strategies used to help accomplish this depend on the type of intellectual property involved and whether the transaction is structured as a sale or a license.

Sale

As discussed, under Sections 544 through 548 of the Code, a trustee may avoid certain transfers. With respect to a sale of technology or intellectual property, the key provisions are: Section 544, dealing with the trustee's ability to avoid unperfected transfers; Section 547, dealing with preferences; and Section 548, dealing with fraudulent transfers.[45] A purchaser of intellectual property should take certain steps to ensure that the transfer cannot be avoided under these provisions.

First, in transaction planning, the transferee should take steps to reduce the likelihood that a transfer is characterized as a preference or a fraudulent transfer. Of the two provisions, the preference provision may be of a more limited scope. By its terms, it only applies to the extent the transferee was already a creditor[46] of, or had any type of existing claim against, the transferee at the time of the transfer,[47] so in many cases it will be wholly inapplicable. In addition, the provision only applies if the transferor is insolvent prior to, or is rendered insolvent by, the transfer and does not apply if new value was given in exchange for the transferred property. For this reason, if the transferee is a prior creditor of the transferor and there is any possibility that the transferor is or may be rendered insolvent by the transaction, the transferee should ensure that the transfer is a contemporaneous transfer for roughly equivalent value. The transfer documentation should contain a recital stating as much, along with specifics of the value given and received. When the value of the consideration given by either party is in doubt, it may be worthwhile to get a third-party appraisal or estimate. Although not controlling, a representation in the agreement that the transferor is solvent should also be considered, where applicable.

In addition, Section 547(e) states that a transfer is deemed made when it takes effect between the transferor and transferee, if perfected within 10 days or, if not so perfected, upon the sooner of when the transfer is perfected or commencement of the bankruptcy case. For this reason, any transfer that may be considered preferential, should be recorded in the appropriate office (whether the United States Patent and Trademark Office (PTO), US Copyright Office, or relevant office under the UCC, as discussed *infra*) within 10 days of its execution or effective date.

Similar steps should be taken with respect to potential fraudulent transfers. Obviously, a transferee should be cautious of any transaction that it believes could be characterized as made with the intent to hinder, delay, or defraud the debtor's creditors. Even if the transaction is not susceptible to such characterization, steps similar to those discussed in the context of preferences should be taken: the consideration should be made for reasonably equivalent value (and steps should be taken to document the value received); and the agreement should recite that the debtor is solvent, is not undercapitalized, and is not overleveraged.

However, none of the above representations and recitals are completely foolproof. A bankruptcy court will look to objective proof of all the factors involved under Section 547 or 548.[48] If a transferee has any doubt as to whether the transferor may be insolvent, or whether the transfer is for reasonably equivalent value, it should attempt to minimize the potential damage arising from the avoidance of the transfer. The transferee should structure payment over the life of the technology instead of up-front payments or lump-sum payments so that less money is outstanding at any time,[49] and the transferee should have a plan to replace the technology if the transfer is avoided.

A technology transferee (or licensee) should also consider liability issues. If there is a concern about the financial stability of the seller or licensor, any indemnities contained in the agreement may end up being worthless. If this is the case, the transferee should consider whether additional insurance is warranted.

With respect to a purchaser of intellectual property or technology, it is important that the purchaser conduct a lien search in the secretary of state's offices and county offices in each jurisdiction in which the seller has assets or does business (after June 30, 2006, searches only need to be conducted in the secretary of state's offices in the state in which the seller is organized) and, if relevant, the PTO or Copyright Office or the appropriate foreign offices. If there is a lien recorded, the purchaser should ensure it is released prior to purchase. The purchase agreement should also contain a representation that there are no liens or security interests in the transferred property.

Finally, following the transaction, the transferee should be sure to promptly record the assignment of any patent, trademark, or copyright transferred. Section 261 of the Patent Act provides that an assignment, grant or conveyance of a patent is void against any subsequent purchaser or mortgagee for valuable consideration, without notice, unless it is recorded in the PTO within three months from its date or prior to the date of the subsequent purchase or mortgage.[50] Section 1060 of 15 USC provides the same three month time period with respect to trademarks. The time period for recordation of a copyright assignment is one month if it is executed in the United States and two months if it is executed outside the United States.[51] Filing within the applicable statutory time period will prevent the trustee from avoiding the transfer using the Section 544 "strong-arm" powers. As discussed, the transfer should be recorded within 10 days if there is any question of the transfer being a preference.

License

In a license of intellectual property, the primary concern of the licensee is usually the continuation of the license agreement. In addition, the licensee may have rights to ongoing improvements. Many licenses also include the provision of services by the licensor to the licensee (for example, ongoing maintenance and support from a licensor of software).

One step the licensee can take to mitigate risks associated with its own bankruptcy is to negotiate a provision that allows it to assign the relevant agreement in connection with a sale of the business to which it relates (which should specify that it applies regardless of whether such sale is by way of merger, operation of law, sale of assets, or otherwise). This approach will help overcome a licensor's argument that the licensee cannot assume and/or assign the license should the licensee undergo a bankruptcy reorganization.

A slightly different approach should be used when addressing the potential risk of a licensor bankruptcy. For the types of intellectual property licenses covered by Section 365(n) of the Code, the license agreement should expressly state that Section 365(n) is applicable. If there could be any doubt as to what "intellectual property" is the subject of the license, or if the license covers intellectual property that is subject to 365(n) and intellectual property that is not, then the agreement should specify what it is intended to cover. In addition, any specific embodiments of intellectual property that the licensee would wish to be provided or to be permitted to have access should be referenced as well. For example, if there is source code to which the licensee would want access, it should be specifically referenced as an embodiment of intellectual property. Further, any separate agreement governing such embodiment (such as the source code escrow agreement) should expressly state that it is supplementary to a license of intellectual property.[52] Finally, if there are payments to be made under the agreement both in consideration for the license grant and for services, it should clearly delineate between the two, because the licensee will be required to continue to make any payments that are in consideration of the grant of license, but likely would not be required to continue to pay for services that have terminated.

When the license involves a trademark or other type of intellectual property not covered by Section 365(n), the licensee's options are more limited. The first option is for the licensee to take a first-priority security interest in the trademark being licensed. This security interest would be granted to secure the performance of the trademark license by the licensor. It is important that this security interest be a first-priority security interest, as otherwise the collateral would be unlikely to survive the claims of creditors with security interests senior to the licensee. The first-priority security interest should be coupled with a liquidated damages provision setting forth the damages that the licensee expects to suffer if the contract is terminated by the licensor and states that rejection of the contract is a breach that entitles the licensee to terminate the agreement. By creating a secured claim out of any rejection, the security interest creates a disincentive for the licensor to reject the license, as there will not be as great of a financial gain to the estate compared with the rejection of an unsecured claim. This mechanism reduces the probability of rejection of the trademark license but does not eliminate it entirely. Following any such termination, the licensee could foreclose on the trademark in order to realize on this claim. In taking any such security interest, it is important to ensure that any prior security interest is released, and that the security interest be perfected as soon as possible following the execution of the agreement.

Another method, which seeks to directly prevent a bankruptcy rejection of the trademark license, is the establishment of a bankruptcy-remote entity to hold the licensed trademarks.[53] This entity would have the sole purpose of holding the relevant trademarks and licensing both the licensor and the licensee. Its governing documents would be structured to prevent the entity from engaging in any activity that would threaten its bankruptcy-remote status, such as incurring any debt, engaging in any business, or declaring bankruptcy without the consent of both the licensor and the licensee (usually structured as a majority of two classes of shares, one owned by the licensor and one by the licensee). The parties should also be careful to observe the corporate formalities for the bankruptcy-remote entity to minimize the risk it be consolidated with the licensor in any bankruptcy.

The ownership of the bankruptcy remote entity can be structured in a number of ways. Each party could own 50 percent of the equity of the entity, or each party could own 100 percent of a particular class of equity interests. Transfer of these interests should be restricted, with each party having a right of first refusal to purchase the other's interest at a set price should the other declare bankruptcy or otherwise attempt to transfer its interest.

This mechanism is intended to prevent a rejection of the trademark license in any bankruptcy of the licensor, and to prevent the bankruptcy remote vehicle from ever being in bankruptcy itself. It can be combined with the security interest described above (with the bankruptcy remote entity granting the security interest) for added protection.

When transferring trademarks to the bankruptcy remote entity, it is important to structure the transfer to minimize risk that the transfer is characterized as an assignment in gross (an assignment without the related goodwill). The transfer should expressly include the goodwill associated with the transferred marks. The transfer may also include any materials relevant to quality control of the marks, such as product formulas and usage guidelines. Finally, the bankruptcy remote vehicle should exercise quality control over the transferred marks (although the licensor could take on responsibility for quality control by contract with the bankruptcy remote vehicle). All of these actions are designed to satisfy trademark law requirements surrounding transfer and licensing of trademarks that, if not met, may jeopardize a trademark's validity or enforceability. These points are very important, as maintaining the licensed right to the trademark but impairing the validity or enforceability of the trademarks itself is not likely to be in either party's interest.

A licensee will also need to take steps with respect to revised Article 9 of the UCC. If the license is exclusive, or outside the ordinary course of business (or could reasonably be argued to be outside the ordinary course of business), the licensee should check for liens and have any applicable liens released. If the license is not exclusive, and definitely in the ordinary course of business, a representation should be included in the agreement that the license granted therein "is a nonexclusive license to a general intangible, is granted in the ordinary course of business and comports with the usual or customary practices in the kind of business in which the licensor is engaged or with the licensor's own usual or customary business practices."

Finally, with respect to any intellectual property license, if the license is exclusive it should be registered with the PTO within three months or US Copyright Office within one month of it being made in order to perfect the licensee's interest therein. While these types of licenses have generally not been challenged in bankruptcy due to failure to record, a recent Ninth Circuit case may provide grounds to do so.[54]

Technology Transferor

Sale

The key interests of a seller of technology or intellectual property is usually going to be ensuring it receives payment. Having the buyer default on its payment obligations, or having a bankruptcy court characterize the transfer as fraudulent or a preference, can deprive the seller of the benefit of the bargain, and it is important to take the necessary steps to help guard against this risk.

The steps described previously with respect to preferences and fraudulent transfers have equal applicability here. The documentation should recite that the transfer is, and the transfer should in fact be, a contemporaneous transfer for roughly equivalent value. Specifics of the value given should be described in the documentation. A third-party appraisal or estimate of value can be obtained. It is also probably worthwhile to include a representation in the agreement that the transferor is solvent (unless the transferee believes it is not), although this statement would not be controlling. In addition, in order to secure any payments that are made over time, a transferor should consider obtaining and perfecting a security interest in the transferred property.

License

A licensor of intellectual property, while clearly still interested in payment, may have additional concerns. A trademark licensor will be interested in the licensee maintaining appropriate quality control; a licensor of know-how may want to be certain that the licensee maintains adequate confidentiality and security standards. Many licensors will want to ensure that the license is not assigned to an undesired third party.

The license agreement should specify if the breach of particular sections (quality control, confidentiality, or the like) should be considered material, to make termination for breach more easily available (although the licensor will still need to petition the bankruptcy court to terminate the agreement). Preventing assignment may be more difficult. Because bankruptcy law will trump an anti-assignment provision in the agreement,[55] the company is faced with few options. The best option is to structure the agreement so that it resembles the type of agreement that, under the Code, cannot be assigned without consent, for example, agreements under which the "applicable non-bankruptcy law" prevents assignment of the contract.[56] The most frequently cited example of an agreement that is not assignable under the "applicable non-bankruptcy law" is the personal services contract.[57] One frequent definition of a personal services agreement is a contract predicated on a relationship of personal trust and confidence, though since state law determines what qualifies as a personal services agreement, there will be variations by jurisdiction. While some agreements may not readily fall under this definition, it may be possible to reference certain special skills and experience of the licensee that are being relied on by the licensor (especially in collaborative situations). If particular employees are important to the project, they should be named in the agreement as well. The addition of this language may serve to bolster the licensor's arguments in a bankruptcy proceeding, although would be unlikely to be dispositive.

As discussed, some bankruptcy courts have also held that nonexclusive licenses of patents, know-how, and copyrights, and certain exclusive licenses are not assignable in bankruptcy by licensees without the express consent of the licensor, because assignment of these licenses is restricted by applicable non-bankruptcy law.[58] Therefore, if the license could be construed to include any patents, know-how, or copyrighted material, the licensor may wish to incorporate an express license to the relevant patents, know-how, or copyrights in order to strengthen arguments that the agreements cannot be assigned by the licensee if and when it enters bankruptcy. Although the law is still unclear with respect to whether a trademark license can be assigned,[59] if the licensee is to use any of the licensor's trademarks, the agreement should include an express trademark license as well.

Services

Recipient

A recipient of technology or intellectual property-based services may be drastically affected by the bankruptcy of its service provider. Services may degrade or cease to be provided, data in the possession of the service provider may become inaccessible and the recipient may no longer have the internal know-how to replace the service itself. For these reasons, a recipient of technology services should take steps to increase the likelihood that it can obtain continued access to services at consistent service levels or transition to another service provider.

The key issue in most technology service agreements is the quality of the services being provided. A degradation of services is often a predictor of other problems with the service provider, including financial viability. Therefore, the service recipient should ensure that the agreement sets out detailed service levels, and specify that the failure to meet certain service levels will constitute a material breach of the agreement and give rise to the right to terminate the agreement. This termination right should trigger an obligation of the service provider to provide transition assistance (which could include access to data, knowledge transfer, etc.) and a liquidated damages provision designed to cover the cost of transitioning to another service provider (although a liquidated damages provision may have little value in bankruptcy unless coupled with a security interest in appropriate assets, such as those used to provide the services under the agreement).

Although termination for breach of service levels is important, breach may be difficult to prove. A recipient of services may therefore wish to consider bargaining for a right to terminate the agreement for convenience, usually coupled with a payment to the service provider. Such a right could be exercised if the service recipient has information suggesting that the service provider may be in, or will soon be in, financial trouble. As with termination for breach, the provision should provide for transitional service.

Another key concern of a recipient of technology services is preventing the service provider from assigning the contract to an undesired third party. The contract should state that the recipient is entering into the agreement based upon its personal trust and confidence in the service provider, thereby trying to characterize the contract as being personal to the service provider so as to implicate Section 365(c) of the Code. In addition, if the service provider will be utilizing any copyrights, trademarks, patents, or know-how of the recipient, an express, nonexclusive license should be included.

If uninterrupted access to the services is important to the business of the service recipient, it should have a plan that it can implement to obtain the services either itself or through a third party in the event that the service provider fails to provide the services. The recipient should have a back-up plan for obtaining the necessary software, hardware, space, personnel, and data that it is prepared to implement (also an important process to undertake for business continuity and disaster recovery purposes).

Finally, when the services are mission critical, the service recipient should consider forming a bankruptcy-remote entity that would hold the assets and provide the services. In the event of a failure to provide the services, the service recipient would have the ability to step in. While ensuring that the deal's economics are preserved and that the necessary corporate, security, and practical steps are taken to make this a viable approach is complicated, establishing the remote entity may prove well worth the effort when the services are key to the business of the service recipient.

Provider

A service provider is likely to have two key concerns from a bankruptcy perspective. The first is making sure it is adequately protected against a payment default or other significant breach by the service recipient. The other is preventing the agreement from being assigned to an undesired party.

To mitigate the risk of payment default or breach, the contract should specify what constitutes a material breach and should give the service provider the right to suspend provision of the services in the event of breach or non-payment by the recipient. In addition to a broad non-assignment provision, inclusion of an express license to any copyright, trademark, patent, or trade secret used or made available to the recipient (such as a software client) may make it more difficult for the service recipient to assume and assign the contract in bankruptcy.

Conclusion

In conclusion, trying to consider the issues raised by bankruptcy or security interests can add an additional layer of complexity to already complex technology and intellectual property transactions. Not dealing with these issues, and losing access to key intellectual property or services, however, can lead to serious adverse consequences for both licensors and licensees of technology, and service providers and recipients. By taking these issues into account early in the planning process, transactions can be structured to mitigate risks and minimize disruption in the negotiation process.

[1] *See, e.g.,* Michael Hart, "The Chimera of Industrial Policy: Yesterday, Today and Tomorrow," 19 *Can.U.S. L.J.* 19, 36 (1993); *see also* Timothy L. Fort & Cindy A. Shipani, "Corporate Governance, Stakeholder Accountability, and Sustainable Peace," 35 *Vand. J. Transnat'l L.* 379, 382 (2002); "Dismantling the Barriers to Global Electronic Commerce," OECD Doc. DSTI/ICCP (98) 13/FINAL, reprinted in OECD Working Papers, v. 6, no. 56 at 19 (1998).

[2] *See* Risa Lynn Wolf-Smith and Erin Connor, "Bankruptcy Considerations in Technology Transactions," 12 J. *Bankr. L. & Prac*. 317 (2003).

[3] *See* Lawrence P. King *et al.*, Collier on Bankruptcy § 362.03 (15th ed., rev. vol. 2003).

[4] *See* Mann v. Chase Manhattan Mortgage Corp., 316 F.3d 1, 9 (1st Cir. 2003).

[5] Chapter 11 of the Code covers bankruptcy reorganizations, and Chapter 7 governs liquidations.

[6] 11 U.S.C. § 1107; *see also* Matter of Garofalo's Finer Foods, Inc., 186 B.R. 414, 422 (N.D. Ill. 1995).

[7] *See* Madrid v. Lawyers Title Ins. Corp., 725 F.2d 1197, 1200 (9th Cir. 1984), *cert. denied*, 469 U.S. 833 (1984).

[8] *See* In re Cybernetic Service, Inc., 252 F.3d 1039, 1049–1052 (9th Cir. 2001) (exlcusive patent license is "assignment, grant or conveyance" which is properly recorded in the PTO).

[9] *See* Collier, *supra* n.3, at § 547.

[10] State law may also apply with respect to avoidable transfers.

[11] *See id*. at § 548; *see also* 11 U.S.C. § 548.

[12] 11 U.S.C. § 365(b); *see also* Stewart Title Guaranty Ins. Co. v. Old Republic Nat'l Title Ins. Co., 83 F.2d 735 (5th Cir. 1996).

[13] *See* In re CFLC, 89 F.3d 673, 677 (9th Cir. 1996); *see also* Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.,, 756 F.2d 1043 (4th Cir. 1985), *cert. denied*, 475 U.S. 1057 (1986) (finding technology licensing agreement to be executory when one party maintained continuing obligations of notice and forbearance in licensing and the other party maintained a duty of accounting for and paying royalties for the life of the agreement).

[14] Vern Countryman, "Executory Contracts in Bankruptcy: Part I," 57 *Minn. L. Rev*. 439, 460 (1973).

[15] *See* In re Simon Transp. Servs., Inc., 292 B.R. 207 (Bankr. D. Utah 2003).

[16] *See* In re General Dev. Corp., 84 F.3d 1364 (11th Cir. 1996).

[17] *See* In re Orion Pictures Corp., 4 F.3d 1095 (2d Cir. 1993), *cert. denied*, 511 U.S. 1026 (1994).

[18] *See* Lubrizol Enters., Inc., 756 F.2d 1043 (permitting rejecting of license under business judgment rule).

[19] *See* In re Booth, 19 B.R. 53 (Bankr. Utah 1982).

[20] *See id*. at 55.

[21] In re Dornier Aviation (North America), Inc., 2002 WL 31999222, *2 (Bankr. E.D.Va. 2002) ("When the debtor in possession exercises such right [rejection of a contract], either prior to plan confirmation or under a confirmed plan, the rejection is treated as a prepetition breach") *citing* 11 U.S.C. § 365(g).

[22] In re Centura Software Corp., 281 B.R. 660, 669 (Bankr. N.D.Cal. 2002).

[23] It should be noted that the definition of "intellectual property" omits trademarks and is limited to trade secrets, patents and plant patents, patent applications, plant varieties, copyrights and mask works. 11 U.S.C. § 101 (35A). In re Centura Software Corp., 281 B.R. 660 (Bankr. N.D. Cal. 2002), provides a detailed discussion of the exclusion of trademark licenses from 365(n) protections.

[24] In re Centura Software Corp., 281 B.R. at 669.

[25] *Id*.

[26] *Id*.

[27] In re Airlift Intern., Inc., 761 F.2d 1503, 1509 (11th Cir. 1985).

[28] In most cases, there will not be applicable non-bankruptcy law that would serve to prevent licensors of intellectual property from assuming and assigning the relevant agreements.

[29] 11 U.S.C. § 365(c)(1)(A).

[30] *See* In the Matter of West Electronics Inc., 852 F.2d 79, 82 (3d Cir. 1988); *see also* In re Catapult Entm't, Inc., 165 F.3d 747, 749 (9th Cir. 1999), *cert. dismissed*, 528 U.S. 924 (1999).

[31] *See* In re James Cable Partners, L.P., 27 F.3d 534 (11th Cir. 1994) (cable television franchise agreement may be assumed, given lack of applicable law preventing assignment).

[32] *See* Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489, 493 (1st Cir. 1997); In re Cardinal Indus., Inc., 116 B.R. 964, 978–981 (Bankr. S.D. Ohio 1990); Weaver v. Nizny, 175 B.R. 934, 937 (Bankr. S.D. Ohio 1994).

[33] *See* In re Ontario Locomotive & Indus. Ry. Supplies (US), Inc., 126 B.R. 146 (Bankr. W.D.N.Y. 1991).

[34] *See id*. at 148.

[35] *See, e.g.*, In re Catapult Entertainment, Inc., 165 F. 3d 747 (federal law principle against the assignability of nonexclusive patent licenses is rooted in personal nature of nonexclusive license, to extent that the identity of a licensee may matter a great deal to a licensor); In re Patient Education Media, 210 B.R. 237 (Bankr. S.D.N.Y. 1997) (nonexclusive copyright license is personal to licensee, who cannot assign it to a third party without consent of copyright owner).

[36] *See* In re Independent Service Organizations Antitrust Litigation, 203 F.3d 1322 (Fed. Cir. 2000), *reh'g and reh'g en banc denied and cert. denied*, 531 U.S. 1143 (2001) (property right is transferred where exclusive copyright license is granted).

[37] *See* In re Golden Books Family Entertainment, Inc., 269 B.R. 311, 318–319 (D. Del. 2001).

[38] *See* Gardner v. Nike, Inc., 110 F. Supp. 2d 1282 (C.D. Cal. 2000).

[39] *See* In re Hernandez, 285 B.R. 435 (Bankr. D. Ariz. 2002).

[40] *See* McCarthy on Trademarks and Unfair Competition § 25:33 (4th Ed. 2001). It should be noted that the cases cited as authority for the conclusion that a trademark license is not assignable do not appear to support the proposition. *See* Delta Tire Corp. v. Marion, 159 U.S.P.Q. 601 (C.D. Cal. 1968); *see also* Denison Mattress Factory v. Spring-Air Co., 308 F.2d 403 (5th Cir. 1962). At least one case has cited McCarthy for authority that a trademark license is non-assignable. Tap Publications, Inc. v. Chinese Yellow Pages (New York) Inc., 925 F. Supp. 212, 218 (S.D.N.Y. 1996). *See also* In re Rooster, Inc., 100 B.R. 228 (E.D. Pa. 1989) (exclusive license to the Bill Blass name for neckties was not a "personal services contract" and therefore was assignable). In addition, dicta appearing in In re Travelot Co., 286 B.R. 447 (Bankr. S.D. Ga. 2002), implies that a trademark license is not assignable without consent.

[41] Verson Corp. v. Verson Int'l Group, 899 F. Supp. 359 (N.D. Ill. 1995).

[42] *See* Collier¸ *supra* n.2, at §§ 365–367.

[43] 11 U.S.C. § 365(e)(1).

[44] 11 U.S.C. § 365(e)(2)(A).

[45] Leif M. Clark, "Technology Transfers: What If The Other Party Files Bankruptcy?," 21 *STMLJ* 173, 188 (1989).

[46] It should be noted that "creditor" is defined broadly and will apply to a party with virtually any type of claim against the transferor. *See* Collier, *supra* n.2, at § 101.10.

[47] Section 547 covers every mode of transfer, and thus will include licenses. 11 USC 101(54).

[48] In re Berger Industries, Inc., 260 B.R. 639 (Bankr. E.D.N.Y. 2001).

[49] While, pursuant to 11 U.S.C. § 548(c), a transferee has a lien to the extent it gave value to the debtor for such transfer, having to realize on this lien may entail considerable time and effort.

[50] 15 U.S.C. § 261.

[51] 17 U.S.C. § 205(d).

[52] *See* 11 U.S.C. § 365(n)(B)).

[53] Bankruptcy remote trusts and/or escrow arrangements can also be used in appropriate situations.

[54] In re Cybernetic Service, Inc., 252 F.3d 1039.

[55] *See* 11 U.S.C. § 365(f).

[56] *See* 11 U.S.C. § 365(c).

[57] *See, e.g.*, City of Jamestown, Tennessee v. James Cable Partners (In re James Cable Partners), 27 F.3d 534, 538 ("A classic example of a contract under which performance is nondelegable is a personal service contract.").

[58] *See, e.g.*, In re Catapult Entertainment, Inc., 165 F. 3d 747; In re Patient Education Media, 210 B.R. 237.

[59] *See, e.g.*, Thomas J. McCarthy, 4 McCarthy on Trademarks and Unfair Competition § 25:33 (4th ed. 2001) ("While the case law is sparse, it appears to be the rule that unless the license states otherwise, a licensed mark is personal and cannot be assigned."); Tap Publications, Inc. v. Chinese Yellow Pages (New York) Inc., 925 F. Supp. 212 (S.D.N.Y. 1996) ("The right of a licensee to sub-license to others must be determined by whether the license clearly grants such a power" (*quoting* 2 McCarthy on Trademarks and Unfair Competition § 18.14[2] (3d ed. 1996)).