Intellectual property issues in bankruptcy

Neal Colton,
Eric Scherling and
Jeffrey Waxman
Cozen O'Connor

In an economy in which high-technology products and services, software, and media content play an ever-increasing role, intellectual property issues frequently arise in the bankruptcy process. Two of the most significant issues are:

(i) the assumption, rejection, or assignment of contracts for the use of intellectual property; and

(ii) the treatment of security interests in the debtor's intellectual property.

Intellectual property basics

Intellectual property covers a very broad category of interests, including patents, trademarks, and copyrights. Specifically, patents protect the exclusive rights of inventors or discoverers of any new and useful process, machine, manufacture or composition of matter, or any new and useful improvement thereof. Copyrights protect original works of authorship fixed in a tangible medium of expression, including literary, musical, dramatic, pictorial, graphic and sculptural works, motion pictures, sound recordings and architectural works. Trademarks include any word, name, symbol, device or combination thereof used to identify the source of a good or service and to distinguish the goods or services of a person from the goods or services of another. Each of the foregoing categories of property rights is, for the most part, governed by federal law.

Assuming, rejecting or assigning of intellectual property interests

The bankruptcy process is intended to preserve and maximise the value of the debtor's estate to either allow the debtor to reorganise or liquidate its assets for the benefit of creditors. In order to preserve and maximise the estate, debtors are permitted under Bankruptcy Code section 365 to assume, reject, or assume and assign executory contracts. Intellectual property licences are generally considered executory contracts because, at a minimum, each party to the licence has the material ongoing duty to refrain from suing the other party to the agreement for infringement upon the intellectual property covered by the licence. Since intellectual property is often extremely valuable, the ability to assume, assume and assign, or reject licence agreements is a significant issue in many bankruptcy cases. In bankruptcy, issues of assumption, rejection or assignment arise in two contexts: where the debtor is a licensee, and where the debtor is a licensor.

The debtor as licensee

Where the debtor is a licensee, there is often an issue whether the debtor may assume or assume and assign the contract. There is a split among the circuits with regard to the assumption of contacts involving intellectual property. The two leading cases are *Perlman v Catapult Entertainment, Inc* (*In re Catapult Entertainment, Inc*) (1999) and *Institut Pasteur v Cambridge Biotech Corp* (1997).

In *Catapult*, the Ninth Circuit Court of Appeals adopted the "hypothetical test" or "literal test" that does not permit a debtor "to assume an executory contract over the non-debtor's objection if applicable law would bar assignment to a hypothetical third party, even where the [debtor] does not intend to assign the contract… to any such third party."

In *Catapult*, the Chapter 11 debtor, as part of its reorganisation plan, filed a motion to assume certain non-exclusive patent licences. Although the debtor did not seek to assign its licensing agreements, a licensor objected to assumption. The issue before the court was whether section 365 prohibited the debtor from assuming the license without the licensor's consent.

In determining whether the debtor could assume the licensing agreement, the court evaluated subsections 365(c) and (f)(1). Subsection 365(c) expressly precludes the assumption or assignment of executory contracts where applicable law excuses a party from accepting performance from, or rendering performance to, another entity. Subsection 365(f)(1) provides that, contrary provisions in applicable law notwithstanding, executory contracts may be assigned. The court found that the language of subsection (f)(1) states the broad rule: non-bankruptcy law that prohibits, restricts or conditions the assignment of executory contracts "is trumped by the provisions of subsection (f)(1)." Subsection (c)(1) is an exception to the broad rule that provides that where applicable law does not merely recite a general ban on assignment but, instead, more specifically "excuses a party… from accepting performance from or rendering performance to an entity different from the one with which the party originally contracted, the applicable law prevails over subsection (f)(1)." To determine whether "applicable law" precludes assignment of the contract under § 365(f)(1), a court must determine the basis for the "applicable law" to prohibit the assignment of the executory contract, and "only if the law prohibits assignment on the rationale that the identity of the contracting party is material to the agreement will subsection (c)(1) rescue it." The court held that the debtor could not assume the licence without the licensor's consent because federal patent law makes non-exclusive licences personal and non-delegable. Several courts of appeals agree with *Catapult*, including the Fourth Circuit in *RCI Tech Corp v Sunterra* (*In re Sunterra Corp*) (2004), the Eleventh Circuit in *In re James Cable Partners* (1994) and the Third Circuit in *In re West Electronics, Inc* (1988).

In *Institut Pasteur v Cambridge Biotech Corp*, the First Circuit Court of Appeals rejected the hypothetical test and adopted the "actual test" and held that the debtor could assume a contract for the non-exclusive licence. In *Institut Pasteur*, the debtor had entered into a cross-licensing agreement with the licensor for the use of certain patents that prohibited the licensee from assigning or sub-licensing to third parties. As part of its reorganisation plan, the debtor sold all its stock to a competitor of the licensor and sought to assume the licences.

In so holding, the court found that subsections 365(c) and (e) contemplate a case-by-case determination whether the non-debtor party is actually being forced to accept performance by a different party than the party with whom it had originally contracted. The court found that the assumption of the licensing agreement by the reorganised debtors did not force the plaintiff to accept performance by a different party because, under state law, the sale of the debtor's stock did not affect the reorganised debtor's separate legal identity from that of its new owner. Moreover, the court found that the non-assignability provisions in the cross-licences did not address the circumstances of the sale of the debtor's stock but, if interpreted as sought by the licensor, would have terminated the licences even when the debtor's shareholders remained unchanged. Accordingly, the court held that the debtor could assume the contract despite that the licence restricted assignment or sublicensing; and the licensor introduced evidence that it would not have licensed the patent to its competitor.

The majority of the appellate courts that have addressed the issue have adopted the "hypothetical" test rather than the "actual" test, based upon a strictly textual approach to statutory construction. However, the majority of the bankruptcy courts that have considered the issue have adopted the "actual" test to foster the overriding policies of the Bankruptcy Code in maximising a return to creditors and facilitating the reorganisation of businesses. In light of the importance of this issue to many businesses and the virtual preclusion of a Chapter 11 option for many companies in circuits adopting the "hypothetical" test, the final word on this issue is likely to come from Congress or the US Supreme Court.

The debtor as licensor

One of the most significant differences between intellectual property and other types of property in bankruptcy is rights upon the rejection of an executory contract where the debtor is the licensee of intellectual property. Ordinarily, where a debtor rejects an executory contract, the rejection constitutes a breach deemed retroactive to the date of the filing of the debtor's bankruptcy petition and the non-debtor is excused from any future performance. Where, however, the debtor seeks to reject a contract in which it is a licensor of intellectual property (other than trademarks), subsection 365(n) of the Bankruptcy Code balances rights of the parties.

Specifically, subsection 365(n) provides that if a debtor rejects an executory contract where it is a licensor, the licensee is permitted to either:

(i) treat the contract as terminated as if it were a breach entitling the licensee to treat the contract as terminated by "virtue of its own terms, applicable non-bankruptcy law, or an agreement made by the licensee with another entity"; or

(ii) retain its rights under the contract or any supplement thereto, including a right to enforce any exclusive provision in the contract other than any right under applicable non-bankruptcy law to specific performance.

Further, the licensee may elect to retain its rights to use the debtor's intellectual property for the duration of the contract and any period for which the contract may be extended, subject to the limitations under applicable non-bankruptcy law to specific performance of the contract.

Where a licensee elects to continue using the debtor's intellectual property, it must make all royalty payments due under the contract. Further, the licensee must waive any right of set-off with respect to the contract and any claim for administrative expenses arising from the performance of the contract. In exchange, the debtor must:

(i) allow the licensee to retain its rights under the contract;

(ii) to the extent set forth in the contract, provide the licensee any intellectual property held by the debtor; and

(iii) not interfere with the licensee's rights under the contract to the intellectual property, including any right to obtain the intellectual property from another entity.

In *In re Prize Frize, Inc* (1994), the debtor-licensor sought to reject a licence agreement relating to certain vending machines. The licensee did not oppose rejection of the agreement, but disputed that it should be required to pay the past due licence fee payments because its obligation was suspended due to an alleged design defect in the machines. The bankruptcy court entered an order granting the motion and requiring the licensee, if it sought to retain its rights under the licensing agreement, to:

(i) pay all licensing fees then due;

(ii) pay the balance of any licensing fees due in monthly installments; and

(iii) waive any set-off rights and administrative claims.

In affirming the bankruptcy court's order, the Ninth Circuit Court of Appeals found that the debtor had the right to reject the licence agreement, but the licensee was entitled to make its election under subsection 365(n) to treat the contract as terminated or retain its rights. Since the licensee opted to retain its rights, it was obligated to make all royalty payments due under the contract and to waive its set-off rights. The court further found that it is "essential to the balance struck [by subsection 365(n)] that the payments due for the [licensee's use] of the intellectual property should be analysed as 'royalties'."

Effect of bankruptcy on security interests in intellectual property

Proper perfection of security interests in intellectual property is important in bankruptcy due to the ability of trustees to avoid or eliminate unperfected security interests for the benefit of the bankruptcy estate.

Revised article 9 of the Uniform Commercial Code (UCC) governs secured transactions where personal property serves as collateral. Generally, creditors taking a security interest in personal property will perfect the security interest by filing a UCC financing statement under applicable state law. Federal law, however, provides specific requirements for recording certain transfers of interests in copyrights, patents and trademarks. The UCC contains a general "step-back" provision under which article 9 is superseded "to the extent that… a statute, regulation or treaty of the United States pre-empts" its application.

Case law indicates that only in the case of registered copyrights does the applicable federal statute clearly pre-empt the article 9 provisions governing perfection. Accordingly, secured creditors must perfect security interests in registered copyrights by recording them in the US Copyright Office. By contrast, perfection of security interests in trademarks and patents is accomplished by filing a UCC financing statement in the appropriate state filing office in the state where the debtor is located.

In bankruptcy, if a security interest has not been properly perfected prior to commencement of the bankruptcy case, the trustee or debtor-in-possession (together, the "Trustee") can eliminate the security interest under the "strong-arm" avoiding powers of section 544 of the Bankruptcy Code, which places the Trustee in the position of a hypothetical judicial lien creditor, thus bestowing upon it all the rights and powers that a judicial lienholder would have under non-bankruptcy law. The hypothetical judgment lien will have priority over the unperfected security interest and thus, the Trustee will have the power to avoid a creditor's unperfected security interest. The creditor will no longer be entitled to recover the entire amount of its claim, but instead will be entitled only to payment on a pro rata basis after all secured claims first have been satisfied. Determining the proper method of perfecting security interests in intellectual property is therefore critical for the secured creditor.

Copyrights

The Copyright Act sets out the priority scheme for competing transfers of interests in registered copyrights. The Act defines a "transfer of copyright ownership" broadly to include "an assignment, mortgage, exclusive licence, or any other conveyance, alienation, or hypothecation of a copyright or any of the exclusive rights comprised in a copyright." 17 USC § 205(d) further provides:

> As between two conflicting transfers, the one executed first prevails if it is recorded, in the manner required to give constructive

> notice under subsection (c), within one month after its execution in the United States…or at any time before recordation in such manner of the later transfer. Otherwise, the later transfer prevails if recorded first in such manner, and if taken in good faith, for valuable consideration or on the basis of a binding promise to pay royalties, and without notice of the earlier transfer.

In *National Peregrine, Inc v Capital Fed Savings & Loan Ass'n* (*In re Peregrine Entertainment, Ltd*) (1990), the court held that a bankruptcy Trustee could, pursuant to section 205(d) of the Copyright Act, avoid an unrecorded transfer of a security interest. The creditor had filed a UCC-1 financing statement which described its collateral as "all inventory consisting of [amongst others] general intangibles… now owned or hereafter acquired by the debtor." Although the UCC definition of "general intangibles" includes copyrights, in order to perfect its security interest the creditor was required to file notice in the US Copyright Office.

The comprehensive scope of the Copyright Act's recording provisions, and the strong federal interests of predictability and uniformity by virtue of a centralised recording system, supports the view that the Copyright Act pre-empts state methods of perfecting security interests in copyrights and related accounts receivable. Therefore, recording in the US Copyright Office, instead of filing a financing statement, is the required means of perfecting a security interest in a copyright.

It is advisable for a lender to record its security interest in a registered copyright at the Copyright Office. Registration of copyrights is not mandatory, however, and is not required for owners or creators of copyrightable works to receive the benefits of copyright protection. Thus, owners of unpublished works such as computer codes and programs may choose not to register their works to protect trade secrets and avoid the need to re-file with each advancement or modification of their works. The Copyright Act only requires registration if the owner of copyrightable works wishes to pursue an infringement suit in federal court.

In the case of unregistered copyrights, recording with the Copyright Office is impossible. The Copyright Act only addresses the process for recording security interests in registered copyrights. It would appear, then, that federal pre-emption does not occur in such circumstances. The case law is split, however, as to whether a security interest in an unregistered copyright should be perfected by recording in the Copyright Office or through the UCC filing system. In *In re AEG Acquisition Corp* (1991) and in *In re Avalon Software* (1997), the courts held that unregistered copyrights must be registered with the US Copyright Office in order to perfect a security interest in the copyright and ensure priority over a Trustee.

The Ninth Circuit Court of Appeals decided differently in *Aerocon Engineering, Inc v Silicon Valley Bank* (*In re World Auxiliary Power Co*) (2002). In this case, the lender filed a UCC financing statement covering its security interest in the debtor's copyrights in designs, blueprints and software. Since the debtor had not registered its copyrights, the lender was unable to record its security interest with the Copyright Office. The bankruptcy trustee sought to avoid the security interest in the copyrights, arguing that *Peregrine* applied.

The Ninth Circuit held against the trustee, observing that unless a copyright is registered, a secured party is not able to perfect its interest by filing notice in the Copyright Office. Although the UCC defers to federal statutes governing perfection of security interests, the Copyright Act did not pre-empt the UCC since it only deals with the rights of secured parties in registered copyrights. As the Copyright Act does not establish "a priority scheme between conflicting transfers of interests" in unregistered copyrights, a party may perfect its security interest in an unregistered copyright by filing a UCC financing statement with the appropriate Secretary of State.

Since the case law on unregistered copyrights is unclear, secured creditors should require, if possible, the owner of the copyright to register with the US Copyright Office, and then record the security agreement with the Copyright Office. The secured creditor should also file a financing statement in the state in which the debtor is located.

Trademarks

The procedure for perfecting security interests in trademarks and patents differs from that used for copyrights. With regard to trademarks, the Lanham Act, at 15 USC § 1060, provides that:

> An assignment shall be void as against any subsequent purchaser for valuable consideration without notice, unless the prescribed information reporting the assignment is recorded in the United States Patent and Trademark Office within three months after the date of the assignment or prior to the subsequent purchase.

This provision of the Lanham Act is not as broad as the similar provision in the Copyright Act dealing with recording and priority. Whereas the Lanham Act establishes priorities as to assignments, the Copyright Act addresses the "transfer of ownership", which is defined to include not only assignments, but also mortgages, exclusive licences, or any other conveyances, alienation, or hypothecation of a copyright or any of the exclusive rights comprised in a copyright. Since the federal trademark statute does not set forth procedures for perfection and priority schemes for transfers of security interests, courts have concluded that the UCC is not pre-empted in this area. Secured creditors therefore must file a UCC financing statement covering trademarks with the proper filing office. It is prudent nonetheless to record a security interest in a trademark with the Patent and Trademark Office (PTO), in case the transfer in question is later determined to be more akin to an assignment than the transfer of a security interest.

In re 199Z, Inc (1992) held that a bankruptcy trustee could avoid a security interest in a trademark when the security interest was recorded in the PTO but was not recorded with a valid UCC financing statement. The court noted that the Lanham Act only provided for recording of an assignment of a trademark in the PTO. An assignment is an "absolute transfer of the entire right, title, and interest to the trademark." Since a security interest is not an absolute and entire transfer, the Lanham Act is inapplicable to perfection of such an interest. The court accordingly held that a security interest in a trademark cannot be perfected by recording in the PTO, but by filing a financing statement in compliance with the UCC.

Patents

As with trademarks, it is necessary to file a financing statement to perfect a security interest in a patent. The Patent Act, at 35 USC § 261, provides:

> An assignment, grant, or conveyance shall be void as against any subsequent purchaser or mortgagee for a valuable consideration, without notice, unless it is recorded in the Patent and Trademark Office within three months from its date or prior to the date of such subsequent purchase or mortgage.

Failure to record a security interest in a patent with the PTO does not permit a Trustee who is treated as a hypothetical judicial lien creditor under Bankruptcy Code section 544(a) to avoid the security interest. In *In re Transportation Design & Tech, Inc* (1985), the trustee sought to avoid a security interest in a patent by arguing that it had not been recorded in the PTO. The bankruptcy court rejected the trustee's argument, since the Patent Act affected the rights of bona fide purchasers and mortgagees, but not judicial lien creditors. Although a bona fide purchaser holding a recorded conveyance of the ownership right in a patent or a mortgagee who has recorded its interest as a transfer of title may defeat the interests of a secured creditor who fails to file notice of its security interest with the PTO, a Trustee cannot.

According to the court, the relative priority between the secured creditor whose interest in a patent is unrecorded and the Trustee is a subject left to state UCC law: "The trustee is in the position of a hypothetical lien creditor, not a bona fide purchaser. As such, his dispute with Mitsui [the secured creditor] can be governed by the Uniform Commercial Code provisions regulating competing lien claims against the patent without conflicting with the Patent Act's provisions protecting bona fide purchasers of the patent. Absent a clear conflict between the two provisions, the UCC provisions remain applicable."

The Ninth Circuit Court of Appeals was the first circuit court to hear this issue in *Cybernetic Svcs Inc v Matsco Inc* (*In re Cybernetic Svcs Inc*) (2001). There, the court held that a creditor's security interest in a patent had priority over the interest of a bankruptcy trustee despite the fact that the creditor did not record its interest with the PTO.

According to the court, a proper article 9 financing statement was all that was required to perfect the creditor's security interest. The court reasoned that the terms "assignment", "grant" and "conveyance" all connote a transfer in ownership. Transfers of security interests did not fall into this category. In any event, the Patent Act renders unrecorded transfers void as against subsequent "purchasers" or "mortgagees", which the trustee, as a hypothetical judicial lien creditor, was not.

The court thus saw no conflict between article 9 of the UCC and the Patent Act. The UCC was not pre-empted, and by filing a financing statement in accordance with California state law prior to the bankruptcy filing, the creditor held a perfected security interest that trumped the claims of the trustee.

Suggested approach – dual recording in both UCC and federal systems

In summary, secured creditors must record their security interests in registered copyrights with the US Copyright Office, and *must* record their security interests in patents and trademarks in accordance with applicable state UCC law. That being said, the most prudent course of action for secured creditors may be to record security interests in all three kinds of intellectual property in both the appropriate state and federal filing systems.

There are at least three reasons for dual recording of security interests. First, the law governing perfection is in some instances unclear, particularly as it applies to unregistered copyrights, so as to make recording of security interests at both the state and federal levels advisable. Second, while the cases discussed above are persuasive and reflect the current state of the law, there may be contrary positions in the future. Finally, with regard to patents and trademarks, the filing of a UCC financing statement is effective in preserving the priority of a security interest in such property against a judicial lien creditor or a trustee. To obtain broader protection against subsequent purchasers or mortgagees, however, recording a security interest in the US Patent and Trademark Office is prudent since the transfer may be regarded as an assignment, grant or conveyance. If possible, a creditor should record its security interest in intellectual property at the PTO or Copyright Office, as applicable, and in addition, file a UCC financing statement covering "general intangibles" with the appropriate state office.