

**SECURITY INTERESTS IN INTELLECTUAL  
PROPERTY AND LICENSES OF  
INTELLECTUAL PROPERTY  
IN BANKRUPTCY**



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**SECURITY INTERESTS IN INTELLECTUAL PROPERTY**  
**AND LICENSES OF INTELLECTUAL PROPERTY**  
**IN BANKRUPTCY\***

**I. INTRODUCTION**

**A. Attributes of Intellectual Property.**

Intellectual property has certain attributes that differ significantly from other types of property, and each type of intellectual property varies significantly from the other types of intellectual property. There is little correlation between the statutes establishing the rights in the different types of intellectual property. This is also true with respect to the statutes and rules of law governing perfection of security interests in intellectual property, and how licenses of intellectual property are treated in bankruptcy.

**B. Types of Intellectual Property.**

This paper addresses the four major types of intellectual property; namely, trade secrets, trademarks and service marks (“marks”), copyrights and patents. It does not address plant varieties, mask works, or other less prominent types of intellectual property.

**C. United States.**

This paper addresses security interests and bankruptcy concerns with respect to the laws of the United States. Foreign counsel should always be consulted when dealing with foreign intellectual property or when exploiting intellectual property in, or transporting intellectual property to, foreign jurisdictions.

**D. General.**

This paper is not intended to be a primer on the unique aspects of the different types of intellectual property, and assumes that the reader has a general working knowledge of these unique aspects. This paper is intended to alert practitioners to some of the more basic concepts of intellectual property law as they relate to security interests and bankruptcy. It is not intended to be, and cannot be, a definitive treatise on these issues. Hopefully, this paper will assist practitioners in identifying the issues and alert practitioners to situations where additional assistance is advisable. In that regard, when dealing with intellectual property as collateral, or dealing with assets that have associated intellectual property as collateral, or when drafting licenses of intellectual property, lawyers with intellectual property expertise should always be consulted.

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## II. SECURITY INTEREST IN INTELLECTUAL PROPERTY

### A. Creation – Attachment.

1. **State Law.** Creation (i.e., attachment) of security interests is governed by Article 9 of the Revised Uniform Commercial Code (the “UCC”).<sup>1</sup>

2. **General Intangible.** Under the UCC, a “general intangible” is any personal property, including things in action, other than accounts, chattel paper, commercial tort claims, deposit accounts, documents, goods, instruments, investment property, letter-of-credit rights, letters of credit, money, and oil, gas, or other minerals before extraction. The term includes payment intangibles and software.<sup>2</sup> Trade secrets, marks, copyrights and patents and licenses of intellectual property are general intangibles under the UCC.

3. **Power to Choose Applicable Law.** When a transaction bears a reasonable relation to a state and also to another state or nation the parties may agree that the law of either such state or nation shall govern their rights and duties.<sup>3</sup>

4. **Enforceability.** A security interest attaches when it becomes enforceable against the debtor. A security agreement is enforceable if: (a) value has been given; (b) the debtor has rights in the collateral; and (c) there is an authenticated security agreement that contains a description of the collateral.<sup>4</sup>

5. **Security Agreements.** A security agreement should be structured to provide the secured party upon foreclosure the full benefits of the type of intellectual property. Generally, the granting clause in a security agreement should conform to what would be required to assign or otherwise transfer the type of intellectual property and all rights therein and any associated rights.

a. **Trade Secrets.** The unique aspects of trade secrets that must be taken into consideration when creating security interests therein are that trade secrets can mature into other types of intellectual property and that reasonable efforts must be made to preserve confidentiality to maintain “trade secret” status. A security agreement covering trade secrets must not only describe the type of information or data that constitutes the trade secrets, but must also do so in a manner that does not destroy the status of the information and data as trade secrets. Additionally, the security agreement must include sufficient nondisclosure and confidentiality provisions to protect the trade secrets in the pre-foreclosure period and in the post-foreclosure period. Both the debtor and the secured party have a vested interest in

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<sup>1</sup> Reference herein to Sections of Article 9 of the UCC refer to Article 9 as revised by the American Law Institute and the National Conference of Commissioners on Uniform State Laws which became effective in most states on July 1, 2001.

<sup>2</sup> UCC § 9-102(42).

<sup>3</sup> UCC § 1-105(1).

<sup>4</sup> UCC § 9-203(b).



maintaining the trade secret status of the information and data. Parties must remember that nondisclosure and confidentiality agreements are, in essence, licenses of trade secrets.

b. Copyrights. The principal unique aspect of copyrights that must be taken into consideration when creating security interests therein is that copyrights can be unregistered or they can be registered federally with the United States Copyright Office (“Copyright Office”). A security agreement covering copyrights should include not only the copyrights and any registrations thereof and applications therefor, but, in addition, should include all renewals and extensions, and all income, royalties, damages and payments, including damages and payments for past, present and future infringement, and the right to sue for past, present and future infringement. The security agreement should also contain adequate covenants covering perfection of the security interest including filings in the Copyright Office for registered copyrights, filings under the UCC for unregistered copyrights, as well as covenants requiring the debtor to give the secured party notice prior to registering any copyrights with the Copyright Office.

c. Patents. The unique aspects of patents that must be taken into consideration when creating security interests therein are that ideas, concepts and trade secrets can “mature” into patents, and that additional patents (e.g., continuations and continuations in-part) may arise out of existing patents. A security agreement covering patents should not only include the patents, and any patent applications and the inventions and improvements described and claimed therein, but, in addition, should include all reissues, divisionals, continuations, renewals, substitutions, extensions and continuations-in-part of the patents and patent applications, and all income, royalties, damages and payments due or payable thereunder, including the right to all damages and payments for past, present and future infringements, and the right to sue for past, present and future infringements. The security agreement must also have adequate provisions requiring the debtor to perfect the security interest in the UCC records and, for certainty (See Sections II-B-2 and II-B-5 below), with the United States Patent and Trademark Office (“PTO”). The debtor should be required to give the secured party notice prior to filing any patent application with the PTO.

d. Marks. The unique aspects of marks that must be taken into consideration when creating security interests therein are that marks can be unregistered or registered federally with the PTO or with a state, that transfers of marks must include the good will associated with the marks, and that intent to use applications can only be transferred with the entire business to which the underlying mark pertains. A security agreement covering marks should not only include the marks and any registrations thereof and applications therefor, but, in addition, should include all renewals, and all income, royalties, damages and payments due or payable thereunder, including the right to all damages and payments for past, present and future infringements, and the right to sue for past, present and future infringements. The grant should include the goodwill associated with the mark. Because an intent to use trademark application cannot be assigned without assigning the entire business to which the mark pertains,<sup>5</sup> either intent to use applications should be excluded from the terms of the security agreement, or the security agreement must include a security interest in the entire business. The security agreement must also have adequate provisions requiring the debtor to perfect the security interest in the UCC records and, for certainty (See Sections II-B-2 and II-B-6 below), with the PTO. The debtor should be required to give the secured party notice prior to filing any trademark application with the PTO.

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<sup>5</sup> 15 U.S.C. § 1060.



e. Licenses. The unique aspects of licenses that must be taken into consideration when creating security interests therein are that licenses are contracts which are general intangibles under the UCC, that the type of intellectual property subject to the license can affect perfection and how the license is dealt with in the security agreement, and whether the licenses are exclusive or non-exclusive. Licenses are contract rights and generally are treated as general intangibles under the UCC. Accordingly, a security agreement covering license has provisions similar to security agreements covering other types of contracts. Depending, however, on the type of intellectual property involved and whether the license is exclusive or non-exclusive, the security agreement may have to provide for perfection not only under the UCC, but also with the Copyright Office or the PTO.

Often, general security agreements (which are typical in financing transactions) that cover all of debtor's personal property run afoul of the principles enumerated above. Obviously, the foregoing are expressed in generalities and emphasize the need to consult with lawyers familiar with intellectual property and security interests therein if intellectual property collateral is involved.

## **B. Perfection.**

1. Mixture of Federal and State Law. Unlike the creation or attachment of a security interest, perfection of a security interest in intellectual property involves a mixture of state and federal law. Article 9 of the UCC does not apply to particular property to the extent that a statute, regulation, or treaty of the United States preempts Article 9.<sup>6</sup> Filing a financing statement is not necessary or effective to perfect a security interest in property subject to a statute, regulation or treaty of the United States whose requirements for a security interest's obtaining priority over the rights of a lien creditor preempt the UCC's filing requirements.<sup>7</sup> Each type of intellectual property must be looked at separately to determine whether state law (perfection under the UCC) is preempted by applicable federal law.

2. Certainty. It must always be realized that financial institutions require certainty with respect to security interests granted to secure a debtor's obligations. They desire this certainty to make sure that their security interest is perfected and is prior to subsequent transferees or lienholders, unsecured creditors and a potential trustee in bankruptcy or debtor in possession ("T/DIP"). They need to know that if foreclosure is necessary they will be able to realize upon the collateral. Often, attorneys for the debtor are required to provide a legal opinion to the secured party that the security interest is perfected. Because much of the law relating to the perfection of security interests is case law, none of which is from the U.S. Supreme Court, secured parties are often forced to file in two places -- one under the UCC and one under the applicable federal recording statute.

### **3. Trade Secrets.**

a. Recording Statute. Except for the Economic Espionage Act of 1996, trade secrets are governed by state law, primarily the Uniform Trade Secrets Act. There is no state or federal system of recording ownership of trade secrets or transfers thereof.

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<sup>6</sup> UCC § 9-109(c).

<sup>7</sup> UCC § 9-311(a).



b. Where to File. Trade secrets are general intangibles under Article 9 of the UCC. There is no federal law that preempts the UCC with respect to the perfection of security interests in trade secrets, and, accordingly, such security interests are perfected under Article 9 of the UCC.

**4. Copyrights.**

a. Recording Statute. The federal statute governing the recordation of interests in copyrights, provides as follows:

(a) *Conditions for Recordation.* -- Any *transfer of copyright ownership or other document pertaining to a copyright* may be recorded in the Copyright Office if the document filed for recordation bears the actual signature of the person who executed it, or if it is accompanied by a sworn or official certification that it is a true copy of the original, signed document.

. . .

(c) *Recordation as constructive notice.* -- Recordation of a document in the Copyright Office gives all persons constructive notice of the facts stated in the recorded document, but only if:

(1) the document, or material attached to it, specifically identifies the work to which it pertains so that, after the document is indexed by the Register of Copyrights, it would be revealed by a reasonable search under the title or registration number of the work; and

(2) *registration has been made for the work.*

(d) *Priority between conflicting transfers.* -- 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 within *two months* after its execution outside 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.

(e) Priority between conflicting transfer of ownership and nonexclusive license. -- A *nonexclusive license, whether recorded or not*, prevails over a conflicting transfer of copyright ownership if the license is evidenced by a written instrument signed by the owner of the rights licensed or such owner's duly authorized agent, and if

(1) the license was taken before execution of the transfer; or

(2) the license was taken in good faith before recordation of the transfer and without notice of it.<sup>8</sup>

A "transfer of copyright ownership" is defined as "an assignment, mortgage, exclusive license, or any conveyance, alienation, or hypothecation of a copyright or of any of the exclusive rights comprised in a copyright, whether or not it is limited in time or place of effect, but not including a nonexclusive license."<sup>9</sup>

b. Where to File. Because recordation of documents with the Copyright Office gives constructive notice if the applicable copyright has been registered, courts have held that federal law preempts UCC perfection provisions with respect to registered copyrights, and that the predecessor to UCC § 9-311(a) excluded a security interest in copyrights from UCC perfection procedures.<sup>10</sup> The same result should be reached under Section 9-311(a) of Revised Article 9. Consequently, security interests in registered copyrights should be perfected by filing with the Copyright Office, not by filing financing statements under the UCC.

Under the Copyright Act, recordation with the Copyright Office gives constructive notice only if the original work has been registered.<sup>11</sup> Recent decisions have held that federal law does not preempt the UCC with respect to unregistered copyrights; and,

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<sup>8</sup> 17 U.S.C. § 205 (emphasis added).

<sup>9</sup> 17 U.S.C. § 101.

<sup>10</sup> National Peregrine, Inc. v. Capitol Fed. Sav. and Loan Ass'n (*In re Peregrine Entertainment, Ltd.*), 116 B.R. 194 (Bankr C.D. Cal. 1990) (filing UCC-1 financing statements is ineffective to perfect security interest in copyrights).

<sup>11</sup> See *supra* Part II-B-4-a.



accordingly, security interests in unregistered copyrights are perfected under the UCC.<sup>12</sup> There are earlier cases, however, that found to the contrary.

Accordingly, with respect to unregistered copyrights, it is advisable to file under the UCC and, when possible, the Copyright Office. It may be prudent to require that valuable unregistered copyrights be registered to take advantage of the federal copyright recording statute. In the alternative, the debtor should be required in the applicable security agreement to notify the secured party within a reasonable time before a copyright application is made in the Copyright Office to allow the secured party the ability to concurrently file in the Copyright Office to perfect the security interest. When searching for security interests in copyrights, both the Copyright Office records and the UCC records should be searched.

## 5. Patents.

a. Recording Statute. The federal statute governing the recordation of interests in patents, provides as follows:

*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.*<sup>13</sup>

Note that this statute only applies to assignments, grants or conveyances. What constitutes an “assignment” for the purposes of this statute is not always clear. Generally, to constitute an assignment, the entire patent or an undivided interest therein must be transferred, or a grant of an exclusive right to practice the invention within a specified territory.

b. Where to File. As reflected above, the federal patent recording statute only applies to an “assignment, grant or conveyance.” It has been held that these terms do not include a security interest, only a transfer of title.<sup>14</sup> Therefore, federal law does not

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<sup>12</sup> *Aerocon Eng'g Inc. v. Silicon Valley Bank*, 303 F.3d 1120 (9<sup>th</sup> Cir. 2002) (where copyright was unregistered, so that Copyright Act provided no means by which security interest could be perfected, federal law did not preempt UCC perfection provisions and the predecessor to UCC § 9-311(a) did not exclude unregistered copyrights from UCC perfection provisions. Similar results should be obtained under UCC § 9-311(a) of Revised Article 9); *Official Unsecured Creditors' Comm. v. Zenith Prod., Ltd. (In re AEG Acquisition Corp.)*, 127 B.R. 34, 40-41 (Bankr. C.D. Cal. 1991), *aff'd*, 161 B.R. 50, 58 (B.A.P. 9<sup>th</sup> Cir. 1993); *In re Avalon Software Inc.*, 209 B.R. 517 (Bankr. D. Ariz. 1997).

<sup>13</sup> 35 U.S.C. § 261.

<sup>14</sup> *Moldo v. Matsco, Inc. (In re Cybernetic Services, Inc.)*, 252 F. 3d 1039 (9<sup>th</sup> Cir. 2001), *cert. denied*, 534 U.S. 1030 (2002) (security interest in patent is perfected by filing UCC-1 financing statement; the Patent Act only permits recordation of an “assignment” and, although, undefined, “assignment” appears not to include transfer of security interest, only transfer of title).



preempt the UCC with respect to perfection of security interests in patents, and the predecessor to UCC § 9-311(a) did not exclude patents from UCC perfection procedures.<sup>15</sup> Accordingly, a security interest in patents should be perfected under the UCC.

Unfortunately, there is no clear or definitive authority with respect to the method of perfection. There is no U.S. Supreme Court decision and the statutory language is not definitive. Accordingly, if the secured party desires certainty, it is advisable to file both under the UCC and with the PTO. The debtor should be required in the security agreement to notify the secured party within a reasonable time before a patent application is filed with the PTO to allow the secured party to file in the PTO as soon as possible. Similarly, when searching for security interests in patents and patent applications, it is advisable to search both the UCC records and the records maintained by the PTO.

## 6. Marks.

a. Recording Statute. The federal statute governing the recordation of interests in marks, provides as follows:

*An assignment shall be void as against any subsequent purchaser for a valuable consideration without notice, unless the prescribed information reporting the assignment is recorded in the Patent and Trademark Office within 3 months after the date of the assignment or prior to such subsequent purchase. The Patent and Trademark Office shall maintain a record of information on assignments, in such form as may be prescribed by the Director.*<sup>16</sup>

b. Where to File. Unlike the patent recording statute, the federal recording statute governing marks refers only to “assignments,” but otherwise is very similar to the patent recording statute. It has been held that the word “assignment” in the statute refers only to transfer of title, not to grants of security interests.<sup>17</sup> Therefore, federal law does not preempt the UCC with respect to perfection of security interests in marks, and the predecessor to UCC

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<sup>15</sup> Accord, *In re Transportation Design and Technology, Inc.*, 48 B.R. 635 (Bankr. S.D. Cal. 1985).

<sup>16</sup> 15 U.S.C. § 1060 (emphasis added).

<sup>17</sup> *Trimarchi v. Together Dev. Corp.*, 255 B.R. 606 (D. Mass. 2000) (Trademark Act does not preempt state law by requiring recordation of “assignment” with PTO because, as used by the Trademark Act, “assignment” refers only to transfer of title, not to transfer of security interest).



§ 9-311(a) did not exclude marks from the UCC perfection procedures.<sup>18</sup> Accordingly, security interests in registered marks and applications therefor should be perfected by filing under the UCC. Unregistered marks should also be perfected by filing under the UCC.

Unfortunately, like patents, there is no U.S. Supreme Court decision and the statutory language is not definitive. Accordingly, if the secured party desires certainty, it is advisable to file both under the UCC and, with respect to federally registered marks or applications therefor, with the PTO. The debtor should be required in the security agreement to notify the secured party within a reasonable time before an application to register a mark is filed with the PTO to allow the secured party to file in the PTO as soon as possible. When searching for security interests in marks, it is advisable to search both the UCC records and, with respect to federally registered marks or applications therefor, the records maintained by the PTO.

7. **Licenses**. A license of intellectual property is a general intangible under Article 9 of the UCC; and, if it is truly a license, a security interest therein would be perfected under the UCC like any other contract right. Often, a so-called license, particularly an exclusive license, can have so many attributes of ownership that, in essence it becomes an assignment or sale. Unfortunately, when a license becomes an assignment or sale depends on the type of intellectual property involved and the terms of the license and is not always easy to determine.

a. **Trade Secret**. A security interest in a license of trade secrets (including a nondisclosure or confidentiality agreement) should be perfected by filing under the UCC.

b. **Copyrights**. As reflected above, the copyright recording statute specifically applies to a “transfer of copyright ownership,” which includes an exclusive license, but does not include a nonexclusive license.<sup>19</sup> Accordingly, a security interest in an exclusive license of a registered copyright should be filed with the copyright office to perfect the security interest, but a security interest in a nonexclusive license should be perfected under the UCC.<sup>20</sup> As reflected above, the copyright recording statute requires the original work to be registered and it has been held that federal law does not preempt state law with respect to unregistered copyrights.<sup>21</sup> Accordingly, security interests in licenses (either exclusive or nonexclusive) of unregistered copyrights should be perfected by filing under the UCC.

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<sup>18</sup> Roman Cleanser Company v. National Acceptance Co. of Am. (*In re Roman Cleanser Co.*), 43 B.R. 940 (Bankr. E.D. Mich. S.D. 1984), *aff’d*, 802 F.2d 207 (6th Cir. 1986); Joseph v. 1200 Valencia, Inc. (*In re 1992, Inc.*), 137 B.R. 778 (Bankr. C.D. Cal. 1992). *See also* Moldo v. Matsco, Inc. (*In re Cybernetic Services, Inc.*), 252 F.3d 1039 (9th Cir. 2001), *cert. denied*, 534 U.S. 1130 (2002) (pertaining to security interests in patents, but because of the similarity of the trademark recording statute with the patent recording statute, the analysis should be applicable to security interests in marks).

<sup>19</sup> 17 U.S.C. § 101. *See* discussion *supra* Part II-B-4-a.

<sup>20</sup> *See supra* Part II-B-4-a.

<sup>21</sup> Aerocon Eng’g, Inc. v. Silicon Valley Bank, 303 F.3d 1120 (9<sup>th</sup> Cir. 2002).



c. Patents and Trademarks. Security interests in marks and patent licenses (provided they are not considered assignments or sales) are generally not filed with the PTO. Unfortunately, when a patent or trademark license becomes an assignment or sale (which means it would be subject to the patent and trademark recording statutes) depends on a number of factors and it is not easy to determine. It is advisable that anytime a patent or trademark license taken as security approaches an exclusive license that the security interest therein be perfected by filing with the PTO in addition to the UCC.

**C. Miscellaneous UCC Provisions.**

1. **Section 9-408.** One of the principal concerns in connection with security interests in intellectual property is whether there is a prohibition against assignment or other transfer of the intellectual property that would be violated either by the granting of the security interest or the transfer of the intellectual property upon foreclosure thereof. The recently enacted Revised Article 9 of the UCC renders ineffective a restriction on transfer, in a license or arising under other law, to the extent the restriction would interfere with the creation, attachment or perfection of the security interest.<sup>22</sup> Revised Article 9 does not interfere with the enforceability of an otherwise effective restriction in the license or under other law on the secured party's enforcement of its security interest in the license.<sup>23</sup> Accordingly, a security interest in a license that by its terms prohibits a transfer or the granting of a security interest, is effective notwithstanding such restriction; but the secured party is not entitled to enforce the security interest if such enforcement would violate the restriction.

2. **Where to File Under the UCC to Perfect .** Although the intricacies of the UCC are beyond the scope this paper, if a security interest is required to be perfected under the UCC by filing, the law of the state where the debtor is located governs perfection.<sup>24</sup> A “registered organization” (defined in UCC § 9-102 as an organization organized solely under the law of a single state which state must maintain a public record of such organization, such as most corporations, limited partnerships and limited liability companies) is deemed to be located in the state where it is organized.<sup>25</sup> With respect to individuals and organizations other than registered organizations (e.g., trusts, partnerships, associations, foreign (non-U.S.) corporations, nationally chartered organizations, etc.), the rules are not as simple.<sup>26</sup>

**III. LICENSES OF INTELLECTUAL PROPERTY IN BANKRUPTCY**

**A. Executory Contracts.**

There are two principal concerns relating to intellectual property in bankruptcy; both relate to licenses of intellectual property and the ability of the T/DIP to assume or reject executory contracts.

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<sup>22</sup> UCC § 9-408(a) and (c).

<sup>23</sup> UCC § 9-408(d).

<sup>24</sup> UCC § 9-301.

<sup>25</sup> UCC § 9-307(e).

<sup>26</sup> UCC § 9-307.



Under the Bankruptcy Code, “executory contracts” may be “assumed” or “rejected” by the T/DIP subject to various exceptions and the approval of the court.<sup>27</sup> If a contract is rejected, the contract is breached retroactively as of the date the debtor filed for bankruptcy, and the creditor’s claim for damages as a result of such breach becomes a pre-petition unsecured claim. If the T/DIP assumes an executory contract it must demonstrate the ability to cure past defaults under the contract and meet future obligations; that is, “provide adequate assurance” that it will be able to cure past defaults and meet future performance.

1. **What Is an Executory Contract.** Generally, an executory contract is a contract under which substantial performance remains on both sides. A contract that has been fully performed on either side is generally not executory.

2. **Licenses as Executory Contracts.** Generally, with very limited exceptions, a license of intellectual property is an executory contract. The obligation to be performed by the licensor is the obligation not to sue for infringement; and the obligation of the licensee is to use the intellectual property in accordance with the terms of the license. Certain licenses, particularly exclusive licenses, may grant so much indicia of ownership that they are not truly licenses, but transfers or sales. In addition, a license that is a mere waiver of the right to sue the licensee for infringement, without any obligation on the license (i.e., to mark products with patent notice, quality control, etc.), would likely not be an executory contract.

**B. Acceptance or Rejection of Licenses.**

1. **Rejection of License.** The Bankruptcy Code contains special provisions pertaining to the treatment of licenses of intellectual property that are rejected by the T/DIP licensor. Section 365(n) of the Bankruptcy Code provides as follows:

(1) If the trustee rejects an executory contract under which the debtor is a licensor of a right to intellectual property, the licensee under such contract may elect—

(A) to treat such contract as terminated by such rejection if such rejection by the trustee amounts to such a breach as would entitle the licensee to treat such contract as terminated by virtue of its own terms, applicable nonbankruptcy law, or an agreement made by the licensee with another entity; or

(B) to retain its rights (including a right to enforce any exclusivity provision of such contract, but excluding any other right under applicable nonbankruptcy law to specific performance of such contract) under such contract and under *any agreement supplementary to such contract*, to such intellectual property (including any embodiment of

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<sup>27</sup> 11 U.S.C. § 365(a).



such intellectual property to the extent protected by applicable nonbankruptcy law), as such rights existed immediately before the case commenced, for—

(i) the duration of such contract;  
and

(ii) any period for which such contract may be extended by the licensee as of right under applicable nonbankruptcy law.

(2) If the licensee elects to retain its rights, as described in paragraph (1)(B) of this subsection, under such contract—

(A) the trustee shall allow the licensee to exercise such rights;

(B) the licensee shall make all royalty payments due under such contract for the duration of such contract and for any period described in paragraph (1)(B) of this subsection for which the licensee extends such contract; and

(C) the licensee shall be deemed to waive—

(i) any right of setoff it may have with respect to such contract under this title or applicable nonbankruptcy law; and

(ii) any claim allowable under section 503(b) of this title arising from the performance of such contract.

(3) If the licensee elects to retain its rights, as described in paragraph (1)(B) of this subsection, then on the written request of the licensee the trustee shall—

(A) to the extent provided in such contract, *or any agreement supplementary to such contract*, provide to the licensee any intellectual property (including such embodiment) held by the trustee; and

(B) not interfere with the rights of the licensee as provided in such contract, *or any agreement supplementary to such contract*, to such intellectual property (including such embodiment) including any right to obtain such intellectual property (or such embodiment) from another entity.



(4) Unless and until the trustee rejects such contract, on the written request of the licensee the trustee shall—

(A) to the extent provided in such contract *or any agreement supplementary to such contract*—

(i) perform such contract; or

(ii) provide to the licensee such intellectual property (including any embodiment of such intellectual property to the extent protected by applicable nonbankruptcy law) held by the trustee; and

(B) not interfere with the rights of the licensee as provided in such contract, *or any agreement supplementary to such contract*, to such intellectual property (including such embodiment), including any right to obtain such intellectual property (or such embodiment) from another entity.<sup>28</sup>

**2. General Effect of Section 365(n).** Section 365(n) is designed for the protection of licensees and is applicable when the T/DIP is the licensor and the licensee is the non-debtor party. The general effect of Section 365(n) is that if the T/DIP licensor rejects the license, the non-debtor licensee may either (a) treat the license as terminated or (b) retain its rights under the license for the term of the license, in which event the non-debtor licensee (i) may continue to have its rights under the license (and the T/DIP must provide the intellectual property as required under the license and must not interfere with the rights of the non-debtor licensee) and (ii) must continue to make royalty payments.

In the event the non-debtor licensee elects to retain its rights under the license, Section 365(n) allows the non-debtor licensee to retain its rights to the intellectual property as such rights existed prior to the bankruptcy filing, but does not allow the non-debtor licensee to enforce the T/DIP licensor's ongoing obligations, such as supplying or providing support and maintenance, improvements, updates or new versions. The T/DIP licensor must not interfere with the rights of the non-debtor licensee under the license or any agreement supplementary thereto (such as an escrow agreement);<sup>29</sup> but only permits the non-debtor licensee to enforce those obligations of the T/DIP licensor that are passive in nature (such as exclusivity provisions, agreement by the T/DIP licensor not to sue for infringement, etc.). The non-debtor licensee is

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<sup>28</sup> 11 U.S.C. § 365(n) (emphasis added).

<sup>29</sup> 11 U.S.C. § 365(n)(3).



not entitled to specific performance<sup>30</sup> and waives all rights of setoff and any claims allowable under Section 503(b) of the Bankruptcy Code (claims for administrative expenses).<sup>31</sup>

**3. Intellectual Property Subject to Section 365(n).** For the purposes of the Bankruptcy Code, intellectual property is any (a) trade secret; (b) invention, process, design, or plant protected under Title 35 of the U.S.C. (Patent Act); (c) patent application; (d) plant variety; (e) work of authorship protected under Title 17 of the U.S.C. (Copyright Act); or (f) mask work protected under chapter 9 of Title 17 of the U.S.C.; to the extent protected by applicable nonbankruptcy law.<sup>32</sup> Note that this definition does not include marks. The exclusion of marks from this definition was intentional.

**C. Assignability of Assumed Licenses.**

**1. Assignment Generally.** If an executory contract is a valuable asset of the bankruptcy estate, a T/DIP may desire to assume that contract and then assign it to a third party to obtain the value for the creditors. Section 365(f) allows a T/DIP (whether a licensor or licensee) to do just that, even if the executory contract contains a restriction on assignment:

(f) Except as provided in subsection (c) of this section, notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease under paragraph (2) of this subsection . . .

. . .<sup>33</sup>

This right of assignment would apply to a license of intellectual property that is an executory contract. The exception referred to in Section 365(f) contained in Section 365(c) provides as follows:

(c) The trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if (1) (A) 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 or lease prohibits or restricts assignment of rights or delegation of duties; and (B) such party does not consent to such assumption or assignment . . . .<sup>34</sup>

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<sup>30</sup> 11 U.S.C. § 365(n)(1)(B).

<sup>31</sup> 11 U.S.C. § 365(n)(2)(C).

<sup>32</sup> 11 U.S.C. § 101(35A).

<sup>33</sup> 11 U.S.C. § 365(f) (emphasis added).

<sup>34</sup> 11 U.S.C. § 365(c) (emphasis added).



Accordingly, a license of intellectual property that is an executory contract can be assumed by the T/DIP, but may not be assigned if “applicable law” excuses the non-debtor from accepting performance from or rendering performance to a party other than the debtor.

2. **Applicable Law.** It has been held that “applicable law” referred to in Section 365(c) includes federal trademark, copyright and patent law and the common law relating thereto. If such laws excuse the non-debtor from accepting performance from or rendering performance to a party other than the debtor, the license cannot be assigned by the T/DIP. Unfortunately, “applicable law” is unsettled and there appears to be a split between the circuits, particularly with respect to the assignability of exclusive licenses. The rationale behind federal common law depends on the type of intellectual property involved. The fundamental policy of intellectual property law with respect to patents and copyrights is to encourage invention and creation, and allowing free assignability of non-exclusive licenses would undermine the reward that encourages invention and creation.<sup>35</sup> Whether a license is assignable depends on a number of factors including the type of intellectual property as well as whether the license could be classified as a sale (in which event Section 365(c) is not applicable), a non-exclusive license (in which event it is generally thought that a license is not assignable) or an exclusive license (in which event it is generally thought that a license is assignable).

a. **Trade Secrets.** Trade secrets are a function of state law, and there is no underlying federal common law as to whether licenses of trade secrets are or are not assignable. Accordingly, “applicable law” should be the state, not federal, contract law on assignability. State law appears to be fact sensitive and depends on the relationship of the parties. There appears to be no presumption as to assignability or non-assignability, and the courts look to whether there is a special relationship of trust and an analysis of the specific terms of the license.<sup>36</sup> It is advisable that, in addition to non-assignability provisions, licenses of trade secrets (including any designs, concepts, inventions for which patents have not been applied) should include language indicating that the license is personal to the parties and is founded on a special relationship of trust. This includes nondisclosure and confidentiality agreements.

b. **Copyrights.** Generally, under copyright law there appears to be a presumption of non-assignability. Non-exclusive copyright licenses have been held to be non-

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<sup>35</sup> *In re CFLC Inc.*, 89 F.3d 673 (9<sup>th</sup> Cir. 1996).

<sup>36</sup> *See In re Sentry Data, Inc.*, 87 B.R. 943 (Bankr. N.D. ILL. 1988); *In re Bronx-Westchester Mack Corp.*, 20 B.R. 139 (Bankr. S.D.N.Y. 1982); *In re Optimum Merchants Services*, 163 B.R. 546 (Bankr. D. Neb. 1994).



assignable.<sup>37</sup> It is generally thought that exclusive copyright licenses are assignable.<sup>38</sup> A recent Ninth Circuit decision, however, has held that exclusive licenses are not assignable.<sup>39</sup>

c. Patents. Like copyright law, generally under patent law there appears to be a presumption of non-assignability. A non-exclusive patent license is personal and not assignable under federal common law and, accordingly, a non-exclusive patent license cannot be assigned under Section 365(c).<sup>40</sup> As with copyright licenses, exclusive patent licenses are thought to be assignable. A recent patent case, however, seems to indicate that exclusive patent licenses are not assignable.<sup>41</sup>

d. Marks. Applicable law with respect to marks is even more uncertain. The policy underlying marks is significantly different than the policy underlying patents or copyrights. The policy with respect to copyrights and patents is to encourage invention or creation, but the policy for marks is to encourage the prevention of unfair competition. Accordingly, it is uncertain whether courts will conclude that licenses of marks are assignable or non-assignable. The analysis with respect to the assignability of mark licenses appears to be more like the analysis for trade secret licenses and is fact sensitive, and the courts look to see whether there is any “special personal relationship, knowledge, unique skill or talent” with respect to the parties.<sup>42</sup> As with licenses of trade secrets, in addition to non-assignment provisions which are ineffective under Section 365(f), it may be advisable to express in the license that the rights are personal and that performance is unique and personal to the parties. A number of courts have permitted trademark licenses to be assumed or assigned under Section 365(c).<sup>43</sup>

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<sup>37</sup> See *In re Patient Educ. Media Inc.*, 210 B.R. 237 (Bankr. S.D.N.Y. 1997); *In re Golden Books Family Entm’t Inc.*, 269 B.R. 311 (Bankr. D. Del. 2001).

<sup>38</sup> *In re Golden Books Family Entm’t Inc.*, 269 B.R. 311 (Bankr. D. Del. 2001).

<sup>39</sup> *Gardner v. Nike, Inc.*, 110 F. Supp. 2d 1282 (C.D. Cal. 2000), *aff’d*, 279 F.3d 774 (9<sup>th</sup> Cir. 2002).

<sup>40</sup> See *In re Alltech Plastics Inc.*, 71 B.R. 686 (Bankr. W.D. Tenn. 1987); *In re CFLC Inc.*, 89 F.3d 673 (9<sup>th</sup> Cir. 1996); *In re Access Beyond Tech. Inc.*, 237 B.R. 32 (1999).

<sup>41</sup> *In re Hernandez*, 285 B.R. 435 (Bankr. D. Ariz. 2002). See also *Unarco Indus., Inc. v. Kelley Co.*, 465 F.2d 1303 (7<sup>th</sup> Cir. 1972), *cert. denied*, 410 U.S. 929 (1973); *Troy Iron & Nail Factory v. Corning*, 55 U.S. 193 (1852).

<sup>42</sup> *In re Rooster, Inc.*, 100 B.R. 228, 233 (Bankr. E.D. Pa. 1999).

<sup>43</sup> See *In re Superior Toy & Mfg. Co., Inc.*, 78 F.3d 1169, 1176 (7<sup>th</sup> Cir. 1996) (allowing an exclusive non-transferable trademark license to be assumed); *In re Rooster, Inc.*, 100 B.R. 228 (Bankr. E.D. Pa. 1999) (concluding that exclusive sublicensing agreement to use trade name and trademark was not “personal services contract” which could not be assumed or assigned under § 365(c)).



#### **D. Drafting Considerations.**

The ability of a T/DIP to assign a license under Section 365(f) and of a T/DIP to assume or reject a license under Section 365(n), together with the rights of a licensee under Section 365(n) if the T/DIP is the licensor, raises many drafting considerations. A complete list of these considerations would be virtually impossible and depends on the facts and circumstances surrounding the transaction, the type of intellectual property involved and the other terms and condition contained in the license. Nevertheless, the following are a few of the more important considerations. It is noted that because of the unique aspects of the Bankruptcy Code many of these may not be enforceable in certain situations, but nevertheless should at least be considered.

1. **Executory Contract.** It may be, and often is, advisable to make certain that the license is an executory contract so that Section 365(n) can be evoked if the licensor is the T/DIP. Section 365(n) allows the T/DIP licensor to either assume or reject a license that is an executory contract. If the license is assumed, the T/DIP licensor has to either cure past defaults or provide adequate assurance of being able to do so and provide adequate assurance of future performance under the license. If rejected by the T/DIP licensor, the licensee has the protections contained in Section 365(n). On the other hand, a license that is executory can also be assigned under Section 365(f) by either a T/DIP licensor or a T/DIP licensee unless “applicable law” excuses the other party from accepting performance from, or rendering performance to, a party other than the T/DIP. If executory contract status is desirable, a specific reference in the license agreement to Section 365(n) is advisable.

2. **Security Interests.** Both a licensor and a licensee can benefit from taking a security interest in property to secure the obligations of the other party. These security interests can be in the intellectual property that is licensed, or in other property whether related to the licensed intellectual property or not.

3. **Nonassignment Provisions and Other Restrictions.** Consideration should be given to including provisions in the license that restrict assignment or assumption of the license. While these are not enforceable to the extent provided under Section 365(c), they can have some benefits. In addition, providing in the license that the license is personal in nature and that performance is unique to the parties can help to excuse the non-debtor from accepting performance from the T/DIP under “applicable law,” thus rendering the license not assumable or assignable. Often restrictions on the type of entity that can be an assignee are advisable. These prohibit as assignment to a competitor, or permit an assignment only when the assignee meets certain requirements such as size or revenue thresholds. Furthermore, change in control provisions are also advisable. Such provisions equate a change in control to an assignment and provide for certain remedies (such as termination of the license) upon a change in control.

4. **Unbundling of Royalty Payments.** Under Section 365(n), if a T/DIP licensor rejects a license as an executory contract, the licensee may elect to retain its rights under the license provided it continues to make “all royalty payments” due under the license. If the payments are bundled (that is, there is one payment for all rights the licensee has under the document, such as support and maintenance and other services or rights that are not a license of intellectual property), a T/DIP may claim that the entire payment is royalty. Accordingly, it is best from a licensee’s perspective that amounts payable under the license document be segregated based on the different services or rights provided for in the license document.



5. **Material Breach and Termination.** Provisions should be included in the license that define what constitutes a material breach and when the license may be terminated. Ipso facto clauses (clauses that purport to provide termination rights upon a bankruptcy filing or based upon the financial condition or insolvency of the debtor)<sup>44</sup> are generally not enforceable, but are enforceable if “applicable law” excuses the non-debtor from accepting performance from or rendering performance to a party other than the debtor.<sup>45</sup> Even though termination clauses may not be effective after a bankruptcy filing, they are enforceable before the filing and can provide significant leverage and are often very useful.

6. **Escrow Agreements.** Escrow agreements are often used in intellectual property licenses, and in particular, software licenses. When the licensee receives only the object code (the machine readable code), the source code (the human readable code), together with the related documentation and instructions on how to compile the source code, are escrowed with an escrow agent with instructions to the escrow agent to release the escrowed materials to the licensee upon certain release conditions. Usually, and advisably, the licensor is required to periodically update the escrowed materials so that the escrowed materials are always current. Although typically used in software licenses, escrow agreements can also be beneficial in licenses of other types of intellectual property. While the nuances of escrow agreements are beyond the scope of this paper, there are three very important considerations relating to their treatment in bankruptcy. First, the escrow agreement should be specified to be “supplemental” to the license agreement under Section 365(n) so that the licensee has the right to possession of the escrowed materials under such Section. Second, the license or the escrow agreement should provide a present (not contingent) license to use the escrowed materials upon default. Third, the release conditions should be carefully negotiated and drafted. The release conditions in forms provided by escrow companies are often inadequate to protect the licensee

#### IV. **CONCLUSION**

As the foregoing demonstrates, there is little certainty with respect to security interests in intellectual property or how licenses of intellectual property are dealt with in bankruptcy. The statutes are not specific, and the case law is inconsistent and, at best, confusing. In addition, most of the decisions are at the district court bankruptcy level, with a few inconsistent federal circuit court decisions—and there are no U.S. Supreme Court decisions. This does not give much comfort and creates uncertainty rather than certainty. The result is that with respect to security interests, it is generally advisable to do dual filings: one under the UCC, and one in the applicable federal office. With respect to the assignability of assumed licenses in bankruptcy, it just creates uncertainty that typically will not be resolved until hearings are held.

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<sup>44</sup> 11 U.S.C. § 365(e)(1).

<sup>45</sup> 11 U.S.C. § 365(e)(2). Note that this is the same type of executory contracts that is subject to 11 U.S.C. § 365(c)(1). *See supra* note 31 and accompanying text.