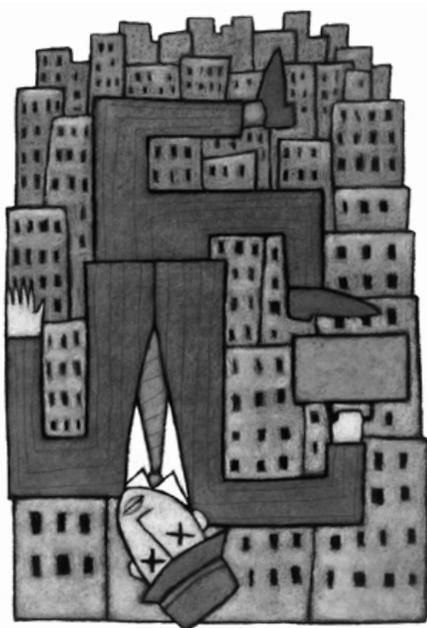


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AFTER THE FALL: What happens to IP licenses during bankruptcy?

By Neil Hirshman, Michael Fatall, and Peter Spingola



Remember the days when the business cycle with all its ups and downs was declared dead and the good times just seemed to roll? Those days are over. Dot-coms have withered, and more established publicly owned companies are struggling as debts have eroded stock prices. For many of these companies, bankruptcy has been the only way out.

Intellectual property rights are often among the most valuable assets of these companies. IP rights are often conveyed by licenses, while in bankruptcy, a party to an IP license

agreement often wishes to sell all or part of its assets, including those licenses. Importantly, when the bankrupt company is the licensee under such an agreement, there are rules that may restrict its ability to transfer certain types of licenses without the licensor's consent. In order to assure proper transfer of rights under an IP license, the debtor, the licensor, and the potential third-party purchaser should be aware of these rules.

Consider the following hypothetical scenario: BrokenRecord.com has filed for bankruptcy and is now looking for a purchaser of the company or its assets. Amalgam Albums is interested, mainly because BrokenRecord is a nonexclusive licensee under the following agreements: (1) a license to a patent covering a new method for transmitting music over the Internet; (2) a license to distribute certain copyrighted music recordings; and (3) a license to use certain trademarks of the musicians responsible for the recordings.

None of the licenses describe whether BrokenRecord can or cannot

assign the licenses to anyone else. In fact, each of the licensors has objected to the assignment of the licenses to Amalgam, and Amalgam has told BrokenRecord that it will not consummate the deal unless it can obtain the licenses.

BrokenRecord's general counsel has advised that bankruptcy law allows these licenses (like most agreements) to be assigned to Amalgam even though the licensors object. Is she correct? Answer: yes and no.

First, some background. BrokenRecord's licenses are generally considered executory contracts, which means that performance is due by both parties to the agreement. Section 365 of the Bankruptcy Code governs executory contracts and gives BrokenRecord three options with respect to an executory contract (subject to bankruptcy court approval): (1) assume the contract such that the parties continue to operate under the contract; (2) reject the contract; or (3) assume and assign the contract to a third party. These options allow BrokenRecord to determine which executory contracts are impor-



tant because BrokenRecord's continued compliance with its obligations under such contracts could be a substantial burden.

Many public companies are going bankrupt. IP rights are often among the most valuable assets that these companies have left.

The advice of BrokenRecord's general counsel reflects the general rule that an executory contract is assignable under section 365, even if the nonbankrupt party objects to such assignment and even if the contract terms prohibit it.

But the section has a narrow exception. BrokenRecord may be prohibited from assigning its licenses to Amalgam without consent of the licensors if: (1) "applicable nonbankruptcy law" excuses the licensor from accepting performance from or rendering performance to a third party; and (2) the licensor does not consent to the assumption or assignment.

Recent court decisions indicate that BrokenRecord's nonexclusive patent and copyright licenses fall within this exception and thus are likely not assignable absent the licensors' consent. Other authority indicates that BrokenRecord's nonexclusive trademark license may be treated the

same way.

When faced with the issue, at least one court has held that federal copyright law is "applicable nonbankruptcy law." This court interpreted federal copyright law to prohibit the assignment of a nonexclusive copyright license without the licensor's consent if: (1) the license contains language that explicitly restricts assignment; or (2) the license says nothing about assignment.

Federal copyright law makes such licenses "personal" to the licensee because it grants a limited monopoly to a copyright holder and thereby allows the holder to determine how the copyright is exploited—including the absolute right to select its licensees. Since BrokenRecord's nonexclusive copyright license does not address whether BrokenRecord can assign the license, the license likely cannot be assigned unless the licensor gives consent.

Similarly, the few courts that have considered whether a nonexclusive patent license can be assigned have concluded that it can't be without the licensor's consent. If the law were different, BrokenRecord might assign the license to the licensor's competitor.

No court has yet applied the "applicable nonbankruptcy law" of trademarks to determine whether trademark licenses can be assigned without the consent of the licensor. But a court may apply the policy

underlying federal trademark law—which seeks to protect the goodwill associated with a particular mark—and hold that BrokenRecord's trademark license cannot be assigned without the licensor's consent.

A trademark owner has a responsibility under trademark law to control the quality of the goods and services sold under its mark or risk losing its trademark. A court may determine that an integral part of this responsibility is the ability to control the licensee's identity.

As in many areas of law, the rules concerning assignability of IP licenses in bankruptcy proceedings are often less than clear.

As in many areas of law, the rules concerning assignability of IP licenses in bankruptcy proceedings are constantly evolving. The issues that arise in bankruptcy are often resolved through negotiation. The economic downturn, on the other hand, will require a bit more work.

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