Protecting Your Rights to Intellectual Property in Bankruptcy

This article was edited and reviewed by FindLaw Attorney Writers (https://www.findlaw.com/company/our-team.html) | Last updated November 09, 2016

A. Introduction.

The United States bankruptcy laws affect intellectual property rights, particularly the rights of secured creditors and licensees. This article first reviews how creditors should protect and perfect their security interests in intellectual property. Next, a licensee's rights in a licensor's bankruptcy are examined with recommendations as to provisions that should be included in every intellectual property license to protect a licensee.

Attached as exhibits are two sample intellectual property perfection documents--a UCC financing statement (http://www.sos.state.tx.us/ucc/forms/ucc1.pdf) to be filed with the relevant state office(s) (typically the Secretary of State) and a security agreement/conditional assignment (https://www.sec.gov/Archives/edgar/data/1448705/000094344012000007/mmax_ex10z4.html) to be filed with the Patent and Trademark Office and/or Copyright Office, both in Washington, D.C.[2]

B. Intellectual Property.

Intellectual property generally includes the following: (a) patent rights, (b) copyright rights, (c) trademark and servicemark rights, and (d) trade secrets.

Patent rights are created and governed by U.S. federal law. Generally speaking, patents cover inventions of a new and useful process, machine or improvement - *e.g.,* integrated circuits, pharmaceutical drugs, disc drives. Patents encourage invention by providing an owner/inventor with a temporary monopoly (generally, 17 years) on the invention, which allows the inventor to control the usage and sale of the invention. However, in order to receive that protection, the inventor must apply for and diligently pursue the patent, or else the patent rights could be forfeited.

Copyrights are also created and governed by federal law. Copyrights cover "originalworks of authorship fixed in any tangible medium of expression" --*e.g.,* books, music,motion pictures, computer programs. A copyright owner possesses the exclusive right to (a) reproduce the work, (b) prepare derivative works from the work, (c) distribute copies of the work to the public, (d) publicly perform the work, and (e) publicly display the work. An author need not register his copyright to get protection--the only requirements are originality and fixation in a tangible expression. However, to sue for infringement (and in order for a secured creditor to properly perfect a security interest in a copyright), the author must register the work with the Copyright Office.

Trademarks and servicemarks arise under federal (Lanham Act) and state law. Thesemarks protect a name, symbol, word or combination thereof used by a person to identify and distinguish his or her goods or services from those provided or manufactured by others. The primary purposes of a trademark or servicemark are identifying the origin of the subject goods or services, and providing some measure of quality assurance. A mark needs to be distinctive or recognizable in order to serve as an identifier (*e.g.,* Pentium, Viagra).

Trade secrets are protected under state law only. Trade secrets are given broadprotection; virtually any information qualifies for trade secret protection if its limited availability gives it economic value and it is reasonably guarded. Examples of trade secrets are customer lists, prices, costs, processes, formulae, and various know-how.

Making Sure Security Interests are Property Perfected

If a creditor obtains a security interest in intellectual property, it is imperative that the security interest be property perfected. In a subsequent bankruptcy, the creditor's security interest may be voided (*i.e.,* cancelled) if that security interest was not properly perfected. The creditor would be left unsecured and without the benefit of its bargain. Briefly,

to perfect their security interests, creditors should confirm that both a UCC financing statement has been filed and, if appropriate, a security agreement/conditional assignment has been recorded in the Patent and Trademark Office and/or the Copyright Office.

Under the Uniform Commercial Code (UCC), intellectual property rights are usually considered "general intangibles," which are perfected by filing a UCC-1 financing statement in the state where the debtor's headquarters are located. However, patents, copyrights and trademarks present some thorny issues with respect to the perfection of security interests, because of the federal system of registration. Also, a security agreement for such collateral needs to be somewhat specialized and tailored to the peculiar nature of the collateral.[3]

In taking a security interest in intellectual property, a secured creditor should ensure that the collateral includes all "now existing and hereafter acquired or created" intellectual property, as well as everything associated with the intellectual property--*e.g.,* film reels, contract rights, license rights, distribution rights, proceeds and income, right to sue for infringement, goodwill, foreign rights. The patents, trademarks and copyrights should be described with specificity--by number, inventor/author, dates, description. The debtor should have an affirmative duty and obligation to promptly register any newly acquired or created patents, trademarks and copyrights (and any upgrades), and the debtor should be obligated to notify the secured creditor of any such newly acquired or created intellectual property, to permit the secured creditor to properly perfect as to the collateral. The security agreement should contain a mechanism to allow the secured creditor to effectively exercise its remedies upon default, *e.g.,* the debtor's agreement to cooperate, and a power of attorney to permit the secured creditor to assign and register the rights upon a foreclosure.

The debtor should covenant to timely file and pay all maintenance fees for the patents, and should also agree that it will notify the secured creditor of any infringement litigation and will cooperate with the secured creditor in protecting the rights and defending that litigation (at debtor's expense). There should also be an indemnity in favor of the secured creditor with respect to third party claims and losses suffered by the secured creditor concerning the intellectual property. The security agreement should include warranties as to the debtor having good and marketable title, no previous assignments, no prior security interests, and the validity and enforceability of the intellectual property. *See* generally *Glazier*[4]*, Patent Strategies for Business* (Third Ed.1997), pp 275-281.

As noted above, a security interest in a general intangible is perfected by filing a UCC financing statement. An exception to perfecting solely by a UCC filing is when the property rights are governed by federal statutes or the property is subject to a federal statute which provides for national registration. UCC §§ 9104(a), 9302(3).

There are no federal statutes that govern the registration of security interests in patents or trademarks. Further, there are two widely-cited court cases that hold that a UCC-1 financing statement perfects an interest in patents. *City Bank & Trust Co. v. Otto Fabric, Inc.,* 83 B.R. 780 (D. Kan. 1988); *In re Transportation Design & Technology, Inc.,* 48 B.R. 635 (Bankr. S.D. Cal. 1985). However, the better practice with respect to patents and trademarks is to also record a notice of a security interest at the Patent & Trademark Office, to protect against subsequent purchasers or competing licensors.

With regard to copyrights, there is an express federal statute governing the recordation of the "transfer of copyright ownership" and documents "pertaining to" a copyright. 17 U.S.C. § 205. A "transfer of copyright ownership" includes a mortgage or hypothecation of the copyright. 17 U.S.C. § 101. Thus, it is mandatory that a secured creditor record its security interest in copyrights with the Copyright Office to be properly perfected. Otherwise, the security interest (if it is only perfected by filing a UCC-1 financing statement) in the copyrighted material *and* any proceeds thereof can be avoided in a subsequent bankruptcy. In re Peregrine Entertainment, Ltd., 116 B.R. 194 (C.D. Cal. 1990); *In re AEG Acquisition Corp.,* 127 B.R. 34 (Bankr. C.D. Cal. 1991).

If the copyright has not been registered, but the collateral is copyrightable, the secured creditor must ensure and insist that the borrower register the copyright with the Copyright Office, and the secured creditor should then record its security interest with the Copyright Office. Otherwise, a bankruptcy court could find the secured creditor to be unperfected, thereby losing its security interest in the copyrightable material and all proceeds thereof. *In re Avalon Software, Inc.,* 209 B.R. 517 (Bankr. D. Ariz. 1997). This can have disastrous results. In the Avalon Software case, the secured creditor was found to be unperfected as to software programs that had never been registered with the Copyright Office, as well as unregistered modifications and enhancements to those programs, *and* proceeds from those programs and any licenses thereof. This constituted the vast majority of the debtor's assets, leaving the creditor unsecured as to those assets and in a very unhappy situation.

The solution when dealing with patents, trademarks or copyrights is to record a security interest in the Copyright Office or the Patent & Trademark Office, *and* file a UCC financing statement with the relevant state office(s). Samples of a UCC-1 financing statement and a Collateral Assignment, Patent Mortgage and Security Agreement are attached.

Protecting Intellectual Property Licenses in Bankruptcy

If a licensor of intellectual property files for bankruptcy, the licensee is in a difficult position. For example, licenses typically provide that the licensor has a duty to make upgrades to and provide support and maintenance for the licensed property. When the licensor is in bankruptcy, the licensor may have no desire or means to provide upgrades or support. As described below, licensees should negotiate protective provisions in the intellectual property license in the event of a licensor bankruptcy.

An intellectual property license is generally considered an "executory contract" in a licensor's bankruptcy. An executory contract is one where performance remains due on the part of both parties to the contract or license, such that the failure to perform would constitute a material breach. *In re Robert L. Helms Const. & Development Co., Inc.,* 139 F.3d 702 (9th Cir. 1998); *In re CFLC, Inc.,* 89 F.3d 673 (9th Cir. 1996).

The licensor in bankruptcy has the option of either (i) rejecting the license, (ii) assuming the license and performing, or (iii) assuming the license and assigning it to a third party.[5] If the licensor assumes the license, the licensor must cure all of its defaults under the license or provide adequate assurance that it will promptly cure defaults, provide compensation for any actual pecuniary loss as a result of any defaults,[6] and demonstrate its ability to perform under the license in the future.

If the licensor rejects the license, the rejection is generally treated as a breach of the license as of the date of the bankruptcy filing. The licensee will have a pre-petition claim in the bankruptcy case if there are any damages as a result of the breach. Prior to 1988, the more troubling issue for the licensee of a rejected license arose from the 1986 case, *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.,* 756 F.2d 1043 (4th Cir. 1986). In *Lubrizol*, the court ruled that the licensor's rejection of a patent license agreement terminated the licensee's right to use the patented technology. This result was devastating to licensees, who paid for the license rights and the license rights were critical to the licensees' businesses.

Congress remedied this situation in enacting Section 365(n) of the Bankruptcy Code in 1988. Under Section 365(n), if the licensor rejects the intellectual property license, the licensee may elect to terminate the license or retain its rights to the license. If the licensee elects to retain its rights, the licensor (or trustee, if one has been appointed) is required, to the extent the license so requires, to provide the licensee with any intellectual property in its possession and allow the licensee to exercise all of its rights under the license as such rights existed as of the date of the bankruptcy filing (including exclusivity rights, but specifically excluding any other right to specific performance) for the duration of the license. To retain its rights, the licensee is required to pay all royalties due under the license and the licensee must waive any setoff rights it may have and any administrative claim it may have in the licensor's bankruptcy case.

While Section 365(n) goes far to aid the licensee in a licensor's bankruptcy, there are some shortcomings.

First, "intellectual property" as defined by the Bankruptcy Code does *not* include trademarks. If a trademark license is rejected by the licensor, the licensee will lose its rights to use the trademarks under the license. If trademarks are the relevant and important property licensed, then the licensee will need to rely on other means to protect its trademark license rights. The licensee could take a security interest in the trademarks and associated goodwill to secure the licensor's obligations under the license.[7] Then, if the licensor files for bankruptcy and rejects the license, the licensee can try to obtain relief from the automatic stay and foreclose on the trademarks and goodwill. Second, the licensee can attempt to structure its trademark license so that it is not an executory contract, *i.e.,* the licensor has no duty yet to perform under the license. This latter method would be very difficult to achieve, however, because typically the licensor must at least maintain the trademark and associated goodwill under the license, which would render the license executory. For example, the following obligations have been found sufficient to render a license an executory contract:

- licensee's duty to make royalty payments; debtor's/licensor's warranties and negative covenants not to compete or sell;
- debtor's/licensor's obligations to notify and indemnify against infringement claims; licensee's duty to pay royalties and render accountings.

Warden and Costello, *Technology Licensing: Protecting Licensees Against the Risk of the Licensor's Insolvency,* 3 CEB Cal. Bus. L. Prac. 57 (Spring 1988).

Even where the intellectual property covered by the license is not trademarks and Section 365(n) applies, there are still limitations for the licensee. Under Section 365(n), the licensee, to retain its rights to a rejected license, must continue to pay royalties. Even though a license may designate what the royalty payments are, a bankruptcy court may subsequently review the license and determine that other additional payments due under the license are also royalty payments and must be paid by the licensee to retain its rights. Therefore, it is important when negotiating the license to clearly specify what the royalty payments are and, if other payments are due, what those payments are in

consideration for, such as a manufacturing fee. That way there is less of a risk that a bankruptcy court will subsequently recharacterize such payments as royalties. Warden and Costello, *New Bankruptcy Code §365(n): Limited Comfort for the Technology Licensee,* 10 CEB Cal. Bus. L. Rep. 158 (January 1989)

Intellectual property licenses sometimes have provisions regarding, or a supplementary agreement for, a source code escrow. The licensor will be required to deposit the source code and other intellectual property into an escrow if certain defaults occur, thereby allowing the licensee access to the intellectual property upon default. These types of provisions do not work well in the bankruptcy of a licensor, particularly if a trustee has been appointed, for two reasons. First, license provisions that are triggered upon the filing of a bankruptcy are not typically enforceable against the debtor. Second, if a trustee has been appointed, the trustee typically does not have good access to and knowledge concerning the intellectual property. So, for example, if a license requires the licensor to place all current versions of software and explanatory materials in a source code escrow and provide the licensee with knowledgeable personnel to aid in reviewing the technology upon a bankruptcy filing, it typically won't happen. The licensee will have to rely on its Section 365(n) rights if its license is rejected and it elects to retain its rights to the license. Hopefully in that situation, the intellectual property turned over to the licensee pursuant to Section 365(n) will be the most current version and sufficiently detailed for the licensee to use it without help from the licensor. For that reason, it is a good idea to have the license expressly specify the intellectual property that must be turned over by the licensor if the licensee exercises its Section 365(n) rights. (Remember too that more than one type of intellectual property will likely need to be specified. For example, a copyrightable computer program may be the subject of the license, but to enable the licensee to benefit from the license once rejected by the licensor, the licensee may need access to certain patents and trade secrets of the licensor.)

In addition, any source code escrow should be set up at the time of the execution of the license with the licensor having an affirmative duty to update the source code escrow as the intellectual property is updated. (The licensee should monitor the licensor's performance of these provisions so the most current version of the intellectual property is always in the source code escrow, particularly at the time of the bankruptcy filing.) The license should also provide that the licensee can hire the licensor's employees who are knowledgeable about the intellectual property if the licensor is no longer able or willing to provide assistance under the license. That way, once the licensor files for bankruptcy and rejects the license, the licensee can access the intellectual property from the source code escrow and, if necessary, hire knowledgeable employees of the licensor on a consulting basis to aid the licensee in deciphering and implementing the materials in the source code escrow.

In addition, if possible, the licensee should obtain a security interest in the intellectual property to secure the licensor's obligations under the license. This will provide some leverage to the licensee, to the extent the licensee can show damages under its rejected license. Moreover, it reduces the licensor's incentive to reject the license in a bankruptcy because the rejection will trigger damages of the licensee that are now secured by the intellectual property. Any revenue the licensor realizes from re-licensing or selling the intellectual property must first be used to pay the licensee's secured claim for damages.

To provide additional incentive to the licensor to assume the license in a subsequent bankruptcy, the licensee could try to structure the royalty payments and other license payments to be distributed evenly over the term of the license rather than a "front-end-loaded" license (*i.e.,* a license whereby most of the royalties are paid up front). In a bankruptcy, the licensor may not want to forego relatively certain and substantial royalty and other payment streams to incur the risk of rejecting the license and re-selling the know-how for fair market value. On the other hand, the licensor has more of an incentive to reject the license if it has already received most of the royalties and other license payments.

Conclusion

The rights of secured creditors and licensees can be negatively affected by a bankruptcy of the owner/licensor of intellectual property. None of these problems are insurmountable if timely and properly addressed. This article is intended to raise the awareness of the reader to the problems that may be faced in a bankruptcy and the benefits of taking corrective measures as soon as possible and preferably before a bankruptcy is filed.

Endnotes

[1]Phillip S. Warden is a partner and Maureen C. Dellinger is senior counsel in the San Francisco of Pillsbury Madison & Sutro LLP. John S. Wesolowski is senior counsel in the Silicon Valley office of Pillsbury Madison & Sutro LLP.

[2] The sample documents are provided for illustrative purposes. The reader is alerted that the facts and circumstances of a particular case may require revisions to the sample documents.

[3] The security agreement/conditional assignment attached hereto contains the types of provisions recommended below, but the reader is alerted that the facts and circumstances of a particular case may require revisions to the sample agreement.

[4] Stephen C. Glazier is a partner in the Washington D.C. office of Pillsbury Madison & Sutro LLP.

[5] If a licensee is the party that files for bankruptcy, the licensee may not be able to assume and assign to a third party a license covering patents. Under the Bankruptcy Code section 365(c), if applicable law excuses a party, other than the debtor, from rendering performance to an entity other than the debtor, the contract or license is not assignable. Patent licenses are nonassignable under federal law. Under Ninth Circuit caselaw (generally covering the West Coast of the United States), patent licenses may therefore not be assigned in a bankruptcy without the licensor's consent. *In re CFLC, Inc.,* 89F.3d 673 (9th Cir. 1996). If a licensee wants the ability to assign a patent license (in a bankruptcy situation or not), the licensee should have the license expressly specify it is assignable. (U.S. Circuits other than the Ninth Circuit may look at patent licenses on a case-by-case basis, so licensors should not rely entirely on CFLC unless any bankruptcy case would be in the Ninth Circuit.)

[6] The following defaults do not need to be cured for assumption of the license: defaults that are breaches of a provision relating to the bankruptcy filing, the insolvency or financial condition of the licensor before the closing of the bankruptcy case, the appointment of a trustee, or satisfaction of any penalty rate for the licensor's failure to perform nonmonetary obligations. Bankruptcy Code section 365 z9b)(2).

[7] In this situation, the license should have no limitation on damages, such as incidental or consequential damages. The licensee can then assert a large damage claim for the rejection of the license by the licensor, which would be secured by the trademarks and goodwill.

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