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Bankruptcy Considerations in Technology Transactions

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Technology companies typically own or license essential intellectual property. Through various contracts such as license agreements, cross-license agreements, web site design and development agreements, software development agreements, web page linking agreements, technology sharing agreements, joint ventures for sharing intellectual property rights and other agreements, technology companies operate their businesses using valuable patents, copyrights and trademarks. These contracts are generally deemed "executory contracts" in bankruptcy and are often the most valuable "assets" an e-commerce or dot.com debtor possesses. However, a bankruptcy filing may strip the value of such executory contracts and cripple a company's efforts to reorganize. This article will explore certain bankruptcy rules governing executory contracts of intellectual property and suggest practical methods for maintaining their value in bankruptcy.

Basic Bankruptcy Rules for Executory Contracts

Section 365 of the Bankruptcy Code offers special treatment for executory contracts involving intellectual property. Under the "*Countryman* definition," contracts under which performance remains due on both sides are considered executory for bankruptcy purposes. Although the Code itself contains no definition of the term "executory contract," bankruptcy courts apply the *Countryman* definition to analyze the unperformed duties of each party and thus determine "executoriness."

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Once a contract is deemed to be "executory," §365(a) governs its assumption and rejection. In general, a debtor may exercise "business judgment" to decide whether to assume or reject an executory contract, assessing the benefits and burdens to its business that flow from the contract. If a debtor decides that the benefits of a particular contract outweigh its burdens, it will file a motion with the bankruptcy court requesting that assumption be allowed. In order to assume an executory contract, however, a debtor must cure all defaults under the contract or provide "adequate assurance" that it will promptly cure, and provide adequate assurance of future performance. If a debtor rejects an executory contract, the contract is deemed breached as of the date of the debtor's bankruptcy petition, and the nondebtor party may file a general unsecured claim for damages.

Bankruptcy Obstacles to the Assumption and Assignment by a Licensee in Bankruptcy of Licenses of Patents, Copyrights

If the debtor is a licensee of patents or copyrights, the filing of a bankruptcy petition may trigger a number of unexpected hurdles to continuing essential license rights. An executory contract may not be assigned if "applicable non-bankruptcy law" excuses the non-debtor party from accepting performance from or rendering performance to an entity other than the debtor. Because the courts have concluded that patent and copyright law constitutes applicable non-bankruptcy law that excuses performance from another, the Code prohibits assignment of intellectual property licenses without the consent of the non-debtor party, even if the license in question is silent on any consent requirement.[1]

In addition, many courts have held that a literal reading of Code §365(c)(1) (dealing with assumption and assignment of executory contracts) prohibits even the assumption of an intellectual property license under a so-called "hypothetical test." At the circuit court level, a majority of courts have endorsed the "hypothetical test."[2] These courts reason that a debtor-in-possession (DIP) may not assume an executory contract over the non-debtor's objection if applicable non-bankruptcy law would bar assignment to a hypothetical third party, even where the DIP has no intention of assigning the contract in question to any such third party.

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Obviously, a bankruptcy decision preventing a debtor with critical IP license agreements from assuming those agreements would not only cripple the debtor and its business, but stymie any potential reorganization. Moreover, if the debtor intends to rely on the assignment of valuable license agreements to reorganize its business, a prohibition on assignment would defeat that intention.

Practical Strategies for Licensee/Debtor to Maintain Licenses in Bankruptcy

(a) *Once in bankruptcy, persuade the licensor of the benefits it will receive in permitting a debtor to assume and assign its license.* For example, the prospect of additional license fees or the retention of cross-licenses may be incentives for consent. Involve the licensor parties as early as possible in the bankruptcy, and lobby for their support. If the licensor consents to assignment, the debtor should be permitted to both assume and/or assign the li-

1 Note that trademark law is distinguishable and permits the unauthorized assignment of executory contracts. Courts have concluded that unauthorized assignment does not necessarily implicate infringement unless the use of the trademark by the assignee is likely to confuse, cause mistakes by or deceive customers.

2 *See In re Catapult,* 165 F.3d 247 (9th Cir. 1998); *In re James Cable Partners L.P.,* 27 F.3d 534 (11th Cir. 1994); *In re West Electronics Inc.,* 852 F.2d 79 (3d. Cir. 1988). *But, see Summit Inv. & Dev. Corp. v. Leroux,* 69 F.3d 608 (1st Cir. 1995) (disagrees with "hypothetical test" and applies "actual test," which asks whether actual assignment is contemplated.).

cense under the language of 11 U.S.C. §365(c)(1).

(b) *Allow the license to "pass through" the bankruptcy without assumption or rejection.* At the conclusion of the case, all property of the estate revests in the debtor pursuant to 11 U.S.C. §1141(b). Although a licensor may seek to compel the debtor's assumption or rejection or request relief from the automatic stay in order to terminate the license, the bankruptcy court should permit the debtor to continue to use the license throughout the case as long as the debtor is current on its royalty obligations.

(c) *When negotiating the license agreement, consider adding a bankruptcy clause that affirmatively states that in the event the licensee files for bankruptcy, the debtor/licensee or trustee has the explicit right to assume the license and to continue to use the technology.* To bolster the enforceability of such language, the drafter should state that patent, copyright or other applicable intellectual property law does not control assignment for purposes of the assumption by the debtor of the license agreement. This language may only be appropriate in certain situations, for instance, in the case of a cross-license between parties with relatively equal bargaining leverage.

(d) *Consider making the license an exclusive license.* The characterization of a license as "exclusive" or "nonexclusive" may affect the determination of whether a contractual arrangement is an executory contract in the first place. Under a nonexclusive license, the licensee has a mere right to use the intellectual property, but the licensor retains the rights of ownership. Under an exclusive license, the licensor may be deemed to have transferred title to the licensee in a "non-executory sale."[3] A non-executory sale would not be subject to assumption or rejection under §365 of the Code. Note, however, that the label given to a contractual arrangement is not dispositive, and the courts will look to the true nature and economic reality of the contractual relationship.

(e) *If a joint venture between unrelated parties is contemplated, consider contributing the technology to the venture so that the venture can continue to operate in the event of the bankruptcy of either joint venturer.*

Maintaining Licenses When Licensor Goes Bankrupt

Until the enactment of §365(n) of the Code in 1988, licensees were also at risk when their licensors declared bankruptcy. If the debtor/licensor rejected the license agreement in question for its own business reasons, the licensee would be left with a terminated license and forced to forfeit its license rights.[4] Section 365(n) now provides special protections for licensees to avoid these harsh results.

Under §365(n)(1), the non-debtor licensee may elect to either (a) treat the license as terminated and/or breached and retain a general unsecured claim, or (b) continue to use the intellectual property.[5] If the non-debtor licensee elects to retain its rights, the debtor licensor is only required to (a) provide access to the intellectual property, (b) not interfere with the exercise of the licensee's rights under the license and (c) comply with any exclusivity provision in the license agreement.

The licensee must continue to pay royalties[6] and must waive any rights it may have to setoff or administrative claims for unperformed affirmative obligations of the licensor. In addition to retaining the rights under the license agreement, pursuant to §365(n)(1)(B) the licensee may also retain rights under "any agreement supplementary to such contract." A source code escrow agreement would likely be considered an agreement supplementary to a license agreement.

Importantly, §365(n) protections only apply to "intellectual property," and the term intellectual property as defined in §101(35A) of the Code conspicuously excludes trademarks and trade names. The Second Circuit has indicated in *dicta* that Congress specifically excluded trademarks and trade names from the protection provided to other intellectual property licenses.[7] Hence, rejection of a trademark or trade name license may leave the licensee with no recourse. To avoid this result, a licensee of trademark and other intellectual property rights may attempt to intertwine the various property rights (including royalties that cover all such rights) so that the trademark and trade name rights are bound up with other rights under §365(n).

Using Source Code Escrow Agreements

A source code escrow agreement is a contract among the technology licensor, the licensee and a third party who serves as an escrow agent. The escrow agent provides a repository for the human readable program statements, called the source code. A source code escrow agreement establishes the conditions under which the escrow agent may release the source code to the licensee, such as the filing of bankruptcy by the licensor.

Source code escrow agreements have traditionally been used by licensees attempting to avoid the negative impact of a bankruptcy filing by their licensors. In such circumstances, the existence of a source code escrow agreement may protect the licensee's use of technology despite rejection of a license agreement by the licensor in its bankruptcy. Section 365(n)(1)(B) makes clear that an agreement "supplementary" to the license agreement, such as a source code escrow agreement, should be protected and enforceable when a licensee elects to retain its rights under §365(n).

No cases have been published that test the enforceability of a source code escrow agreement in bankruptcy. One court has suggested that source code escrow agreements should be enforceable,[8] and several bankruptcy cases consider the enforceability of other types of escrow agreements. Those cases hold that escrow agreements are enforceable so long as certain formalities are followed.[9] Following is a discussion of those items that should be included in a source code escrow agreement.[10]

(a) *The escrow agent should be a neutral third party and ideally, a party that specializes in administering technology escrow accounts.* Because a source code escrow agreement is a form of express trust, the escrow agent must serve as a trustee for the benefit of the escrow beneficiary, the licensee. The escrow agent should not be affiliated with either the licensor or licensee other than in its capacity as agent for the escrow.

(b) *The source code escrow agreement should be a written contract that covers the following subject matter.* The source code escrow agreement must clearly identify the property that is to be placed in escrow. The source code escrow agreement must also clearly establish the conditions under which the source code is to be released. In the event

[3] *See In re Independent Serv. Org. Antitrust Litig.*, 203 F.3d 1322 (Fed. Cir. 2000) (asserting that property right is transferred where exclusive license to copyright is granted); (*Ortho Pharm. Corp. v. Genetics Inst. Inc.*, 52 F.3d 1026, 1032 (Fed. Cir. 1995) (recognizing exclusive licensee's right to sue on patent).

[4] *See Lubrizol Inc. v. Richmond Metal Finishers Inc.*, 756 F.2d 1043 (4th Cir. 1985).

[5] Section 365(n) is limited to "intellectual property." Trademarks and tradenames are omitted from the definition of intellectual property under Code §101(35A).

[6] The term "royalty payments" is broadly construed. Even if a payment is called something else, it may be deemed to constitute a royalty payment for the use of intellectual property, such as when payments are based on a percentage of sales of end products that are incorporated into or derived from licensed intellectual property.

[7] *See Licensing by Paolo Inc. v. Sinatra (In re Gucci),* 126 F.3d 380, 394 (2d Cir. 1997); *In re Centura Software Corp.,* 281 B.R. 660 (Bankr. N.D. Cal. 2002). The legislative history, however, suggests that Congress only determined to postpone congressional action in this area and to allow the development of "equitable treatment" by bankruptcy courts. *See* S. Rep. No. 100-505, at 5 (1988), *reprinted in* 1988 U.S.C.C.A.N. 3200, 3204.

[8] *See, e.g., Behr Venture Partners Ltd. v. Bedford Computer Corp. (In re Bedford Computer Corp.),* 62 B.R. 555, 568 n.11 (Bankr. D. N.H. 1986) (suggesting that source code escrow agreement maybe effective).

[9] *See, e.g., Hassett v. Blue Cross and Blue Shield of Greater New York (In re O.P.M. Leasing Servs. Inc.),* 46 B.R. 661, 665 (Bankr. S.D.N.Y. 1985); 5 *Collier on Bankruptcy* §541.09 (15th ed. rev'd. 1997); *cf. e.g., Rajala v. The Holland Corp. (In re Chesapeake Assoc. Ltd.),* 141 B.R. 737, 745 (Bankr. D. Kan. 1992) (holding that an escrow was ineffective because the escrow agent was an agent of a party and not a neutral third party).

[10] For a more detailed discussion, *see* Mobley, Keith, "Protecting IP Assets with Technology Escrow," *The Bankruptcy Strategist,* Nov. 2001 at 6.

that the source code is released, the source code agreement should define the permissible uses for the released source code.

(c) *The source code should be delivered to the escrow agent and be fully documented and commented.* The bankruptcy court must be able to identify the escrowed property and distinguish it from other assets of the debtor. Often licensees and licensors develop new technologies based on existing technology. A fully commented and documented copy of the source code will aid the court in distinguishing the property that is in escrow from the property of the estate.[11]

(d) *An experienced technology escrow agent can help with the administration of the escrow account and can recommend procedures for ensuring that the source code is maintained by the licensor and that documentation and comments are up to date.* The source code escrow agreement should address issues such as updates to and maintenance of the source code, an audit process and termination procedure. An experienced technology escrow agent will likely have a form of escrow agreement that will cover these issues.

Conclusion

Under the Code, the various forms of license agreements used by technology companies are generally held to be "executory contracts." As such, whether you or your clients are licensees in bankruptcy or victims of a licensor's bankruptcy, a bankruptcy filing may strip the value of a license agreement and cripple a company's efforts to reorganize. There are, however, practical devices that can be used to maintain the value of technology licenses in bankruptcy. As a licensee, take steps to ensure that you will be in a position to assume and assign the license in the event you become bankrupt. In the event that the licensor becomes bankrupt, §365(n) offers some protection for licensees. This protection can be bolstered by the use of a source code escrow agreement. ■

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[11] *See Behr Venture Partners Ltd. v. Bedford Computer Corp. (In re Bedford Computer Corp.),* 62 B.R. 555, 568 n.11 (Bankr. D. N.H. 1986) (holding that a venture capital partner cannot reclaim "new technology" from developer partner who filed bankruptcy, because the court was unable to distinguish "existing technology" from "new technology").