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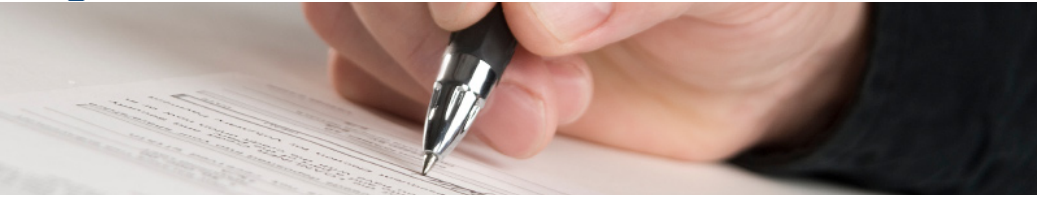

INTELLECTUAL PROPERTY LICENCES AND BANKRUPTCY

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In bankruptcy, the rights of a debtor in intellectual property – copyrights to print books, publish and distribute music, patents on inventions, trade secrets and the like – may be key assets of the bankruptcy estate. Where these rights are simply owned outright and exploited by the debtor, the normal bankruptcy rules on marshalling and disposing of assets apply. However, where a debtor either holds rights as a licensee (a 'licence-in') or exploits its property as a licensor (a 'licence-out'), a unique confluence of special bankruptcy rules and IP law arises. This chapter examines that regime.

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IS THE LICENCE AN EXECUTORY CONTRACT?

Where material performance remains on both sides of a licence agreement, the contract is executory and subject to rejection or assumption in bankruptcy.

Executory Contracts

Many consequences will flow from characterisation of an agreement as executory or non-executory under Section 365 of Chapter 11. That provision authorises a debtor in possession with court approval to assume or reject contracts categorised as executory. To assume or assign an executory contract, the debtor in possession must generally cure all defaults (however, see *In re Fleming Cos*, 499 F 3d 300 (3d Cir 2007), apparently finding a limited exception). Similarly, the protections afforded to licensees of intellectual property under Section 365(n) apply only to executory contracts. If the court concludes that a 'licence' to a debtor is in fact an instalment sale, the agreement is unlikely to be an executory contract.

Countryman test

The Bankruptcy Code does not define 'executory contract'. Courts have traditionally applied the Countryman test: a contract is executory if there remain sufficient performance obligations on each side that failure by one party to perform would entitle the other to withhold performance (eg, see *Griffel v Murphy*, (*In re Wegner*), 839 F 2d 533, 536 (9th Cir 1988); *Otto Preminger Films, Ltd v Qintex Entm't Inc* (*In re Qintex Entm't, Inc*), 950 F 2d 1492, 1495 (9th Cir 1991)). Some have argued for a 'functional' test, looking to see whether deeming a contract executory would advance the goals of reorganisation (see Michael T Andrew, "Executory Contracts in Bankruptcy: Understanding Rejection", 59 U Colo L Rev 845 (1988); Jay L Westbrook, "A Functional Analysis of Executory Contracts", 74 Minn L Rev 227 (1989); *Cohen v Drexel Burnham Lambert Group, Inc* (*In re Drexel Burnham Lambert Group, Inc*), 138 BR 687 (Bankr SDNY 1992); *Thompkins v Lil' Joe Records, Inc*, 476 F 3d 1294, 1306 n 13 (11th Cir 2007) cert denied, 128 S Ct 613 (2007)). Although most practitioners believe that courts do apply a variable standard of executoriness, based on the debtor's role and interest, and the contrary sources cited above argue for such a rule, the Ninth Circuit has indicated that the test should apply equally irrespective of which party is the bankruptcy debtor (Qintex, 950 F 2d 1496).

Licensor's executory obligations

Implicit in every licence is an agreement by the licensor to permit the licensee uninterrupted enjoyment of the licensed property. Unfortunately, some courts have viewed this as a one-time transfer and searched for other continuing obligations of the licensor. This often leads to flyspecking the contract. For example, in *Fenix Cattle Co v Silver* (*In re Select-A-Seat Corp*) (625 F 2d 290, 292 (9th Cir 1980)) the court focused on the licensor's obligation not to license the subject software to a third party. Similarly, in *Qintex* a licensor's obligation to cooperate in colourisation of films licensed to a distributor was held to be a material obligation. In *Lubrizol Enters Inc v Richmond Metal Finishers* (*In re Lubrizol*) (756 F 2d 1043, 1045-46 (4th Cir 1985)) the obligations to notify the licensee of other licences, to give most-favoured licensee rates in the event of such licences and to defend and indemnify with regard to the licensed property were found to make the licensor's obligations executory.

Better-reasoned cases recognise that quiet enjoyment alone is a continuing material performance by the licensor (eg, see *Everex Sys, Inc v Cadtrak Corp* (*In re CFLC, Inc*), 89 F 3d 673, 677 (9th Cir 1996); *Lubrizol*, 756 F 2d at 1045-46). Of course, while these cases dispense with the endless flyspecking for continuing obligations of the licensor, a continuing obligation of the licensee must still be found to meet the classic Countryman test.

Instalment sales

Where the licensor has no continuing affirmative obligations, some courts have found exclusive perpetual 'licences' to be sales or non-executory (eg, see *In re Stein & Day, Inc*, 81 BR 263, 266-67 (Bankr SDNY 1988); *In re Learning Publ'ns Inc*, 94 BR 763, 765 (Bankr MD Fla 1988) – both *Stein* and *Learning Publications* involved book publishing agreements arguably constituting copyright licences); *Zenith Prods, Ltd v AEG Acquisition Corp* (*In re AEG Acquisition Corp*), 127 BR 34, 59-60 (Bankr CD Cal 1991), finding a film distribution agreement to be an instalment sale, not an executory contract, aff'd, 161 BR 50 (BAP 9th Cir 1993); *In re Qintex*, 950 F 2d 1492, contract to use and distribute performed services of actor non-executory). These cases seem correct on their facts, as the perpetual nature of the subject licences makes them more like a sale. Some argue that because the Copyright Act categorises any exclusive licence as a transfer of copyright ownership, all exclusive copyright licences should be treated as sales (17 USC Section 101; see Schuyler M Moore, "Entertainment Bankruptcies: The Copyright Act meets the Bankruptcy Code", 48 Bus Law 567 (1993); AEG, 161 BR at 59; *In re Patient Educ Media, Inc,* 210 BR 237 (Bankr SDNY 1997), suggesting that an exclusive copyright licence may be a completed ownership transfer rather than an executory contract). This seems to misconstrue the purpose of the designation. In the Copyright Act 'transfer of copyright ownership' is a term of art regulating copyright transfer form and recording provisions. This in turn determines which interests may be cut off if unrecorded, but may not be intended to govern the characterisation of the rights in bankruptcy (17

USC Sections 204, 205). Certainly a licensee of an exclusive interest in copyright for a fixed term anticipates that its property will ultimately be subject to further exploitation, just as a lessor leasing 'exclusive rights' to an office or forklift would at the end of the term expect the property to revert.

Debtor as licensor

Notwithstanding rejection of an IP licence in the licensor's bankruptcy, Congress has provided substantial – though incomplete – protection to licensees.

Section 365(n)

In the *Lubrizol* decision the Fourth Circuit found that a non-exclusive licence of a metal-working process was executory. The court further concluded that upon rejection, the licensee's rights to use the process were terminated. This controversial decision threatened the nation's IP licensing system, as licensees would face losing all their rights in a licensor's bankruptcy. Congress quickly provided specific protections to licensees of intellectual property from bankruptcy debtors. On October 8 1988 Congress enacted the Intellectual Property Bankruptcy Protection Act of 1988, which added Section 365(n) to the Bankruptcy Code. While these provisions apply by their terms only to 'executory contracts', courts have generally applied them to licences without the hand-wringing over executoriness noted above (eg, see *Encino Bus Mgmt, Inc v Prize Frize, Inc* (*In re Prize Frize, Inc*), 150 BR 456 (BAP 9th Cir 1993), aff'd, 32 F 3d 426 (9th Cir 1994); *In re El Int'l*, 123 BR 64 (Bankr D Idaho 1991)). At least one case holds that the provisions apply to contracts of any bankruptcy debtor under US law even if the contract is governed by foreign law and involves foreign exploitation of rights (*El Int'l*, 123 BR at 67). However, the definition of 'intellectual property' in the code turns largely on things protected by various sections of the code which may not apply to overseas intellectual property.

Limbo rights

Section 365(n)(4) generally permits a licensee to enjoy its rights during the limbo period prior to assumption or rejection. This period may be quite lengthy. Specifically, the trustee must on written request:

- perform the contract;
- provide the licensee with any embodiment of the intellectual property held by the trustee, to the extent provided for in the agreement; and
- not interfere with any contractual right to obtain an embodiment elsewhere (eg, an escrow or film laboratory).

Option upon rejection

If the licence is rejected, the licensee may treat the agreement as breached, with termination determined by materiality of the breach. The Bankruptcy Code does not explicitly state that the licensee must give up its licence rights if it makes this election.

Alternatively, the licensee may elect to retain its rights, including any right to exclusivity. The licensee may exercise any option to extend the licence term. Increasingly, courts explicitly impose an election date as part of rejection orders, but the code does not generally create such a procedure.

Costs of retaining rights

Retaining rights following rejection imposes certain costs on the licensee.

Royalties

The licensee must make all royalty payments due under the licence. One court has read 'royalty' broadly to include fixed instalment payments, not just the narrower meaning of "periodic payment based upon productivity for use of intangible property" (*Prize Frize*, 150 BR at 459). The enacted legislation substituted the word 'royalty' for the Senate version requiring payment of "all payments due" (134 Cong Rec S 12993-01 (daily ed Sept 20 1988)). *In Schlumberger Resource Management Services, Inc v CellNet Data Systems, Inc* (*In re CellNet Data Systems, Inc*) (327 F 3d 242 (3d Cir 2003)) the court held that the right to receive such payments was not automatically transferred in a sale of the underlying intellectual property, but was a separate severable asset.

No set-off

The licensee retaining its rights is deemed to waive all set-offs with regard to the contract. The breadth of this waiver is subject to some controversy. Although bankruptcy law normally draws a strong distinction between set-off and recoupment – the latter arising under the same contract or series of dealings – some debtors have argued that the prohibition applies to recoupment of contractual advances. Care should be taken to ensure that any permitted recoupment of costs or advances is drafted to minimise this argument. Certainly, the word 'set-off' should be avoided. It may also be better to describe a royalty as 'X per cent after Y dollars in sales', rather than 'X per cent on all sales with a right to recoup Z dollars first'.

Waiver of administrative claim.

In many types of intellectual property, the ability to escape recovery of the licensee's upfront payment can motivate

rejection. Thus, licensees giving large upfront payments – often for product development – should be wary of the ability to recoup after rejection. At least one authority has stated by declaration that Congress intended to bar recoupment (Decl of Kenneth N Klee, filed Jan 23 2004 in *Big Idea Liquidating Creditor Trust v Safeco Ins Co of Am* (*In re Big Idea Productions, Inc*), 372 BR 388 (Bankr ND Ill 2003)). While one hesitates to disagree with such a source, this conclusion does suggest remarkably poor Congressional word choice.

If the licensee retains its rights, it waives any administrative claim. The legislative history is quite sparse on this point. While it may bar only claims based on the trustee's failure to perform in the future, it may also waive any administrative royalty payments for a cross-licence enjoyed by the trustee or debtor in possession during the bankruptcy (see the *DAK* decision below).

Limits of 365(n)

Status of Section rights

Under Section 365(n) a rejected licensee retaining its rights is entitled to those rights "as such rights existed immediately before the case commenced" (11 USC Section 365 (n)(1)(B)). Most commentators and at least one reported decision suggest that this limits the rights to the state of the intellectual property upon commencement of the case (*Biosafe Int'l v Controlled Shredders* (*In re Szombathy*), Nos 94 B 15536, 95 A 01035, 1996 Bankr Lexis 888 (Bankr ND Ill July 9 1996), aff'd in part, rev'd in part 1997 US Dist Lexis 5168 (ND Ill Apr 10 1997)). Thus, if the intellectual property is improved during pendency of the case, Section 365(n) rights do not apply to the improvement. The *Szombathy* decision fails to consider that the enacted statute rejected an earlier circulated draft's clear reference to the licensee's rights to "the intellectual property, as it existed at the filing of the petition". Thus, the enacted version appears to focus not on the state of the intellectual property, but on the less clear "state of the licensee's rights".

In *In re Storm Technology, Inc* (260 BR 152 (Bankr ND Cal 2001)) Judge Morgan adopted a plain meaning reading, ruling that a "springing" licence arising only upon default was not protected by Section 365(n) where no default preceded bankruptcy. She did not specifically address the *Szombathy* rationale or whether Section 365(n) rights would also not apply to newly created property.

Whichever interpretation of the language is adopted, it seems clear that the rejected licensee cannot force the licensor to create new products, such as complete a multi-product deal, perform upgrades or debugs. However, certain issues are uncertain. Assuming the contract permits (and the licensee has the technical ability), can it create such derivative works itself? Alternatively, if the debtor in possession voluntarily carries out such work post-petition, can the rejected licensee demand that the improvement be provided to the licensee? These issues may well turn on whether one focuses on the licensee's rights or the intellectual property on filing. While *Szombathy* would answer these questions negatively, it is the lone reported authority at this point (for a contrary view see Comment, "Unsolved Mysteries of Section 365(n)", 21 Seton Hall L Rev 800 (1991)).

Avoiding powers

The Bankruptcy Code provides the estate with many avoiding powers to set aside fraudulent transfers, transfers unperfected against judgment lien holders and preferential transfers. Where the trustee assumes an agreement it will be deemed to waive these claims (Alvarado v Walsh (In re LCO Enters), 137 BR 955 (BAP 9th Cir 1992), aff'd, 12 F 3d 938 (9th Cir 1993)). However, where the licence is rejected, these powers may come into play. The protections afforded to a rejected licensee under Section 365(n) do not explicitly override the avoiding powers and no reported cases address whether Section 365(n) implicitly overrides the avoiding powers. It would seem likely that the ability to avoid fraudulent transfers should survive, but it is less clear whether a licence that must be recorded to withstand a judgment lien creditor (eg, an exclusive copyright grant) may survive rejection under Section 365(n), but fall prey to the trustee's status as a judgment lien holder under 11 USC Section 544. Although not an avoiding power, a licensee must also beware of motions to sell the intellectual property, as the Seventh Circuit has held that Section 365(n) rights may be cut off by a sale free and clear of other interests *(Precision Indus, Inc v Qualitech Steel SBQ, LLC* (*In re Qualitech Steel Corp*), 327 F 3d 537 (7th Cir 2003)).

Trademarks

By its terms, Section 365(n) applies only to licences of 'intellectual property'. As defined in 11 USC Section 101(35A) that term does not include trademarks. In fact, trademarks were excised from early drafts. In *In re HQ Global Holdings, Inc* (290 BR 507 (Bankr D Del 2003)) Judge Walrath reached the straightforward conclusion that a pure trademark licence is not protected by Section 365(n). More controversial, she concludes (as did the court in *Lubrizol*) that rejection terminates any right of the licensee to use the property. A California bankruptcy judge reached the same conclusions in *In re Centura Software Corp* (281 BR 660 (Bankr ND Cal 2002)). However, many copyright or patent licences include as integral parts a trademark licence. No reported cases clearly address whether the entire contract in this case is governed by Section 365(n) or whether the contract is to be severed into two components – one that attaches Section 365(n) survivor rights and one that does not (but see *In re Matusalem* (158 BR 514 (Bankr SD Fla

1993), apparently concluding that the right to use a trade name for rum is subsumed in the licence to a secret formula, hence governed by Section 365(n)). The Centura court's treatment of the Metasulum 'fundamental nature of the contract' argument is notably confusing.

Debtor as licensee

A bankruptcy debtor may find its rights as licensee under IP licences to evaporate.

Section 365(n) inapplicable

The respective rights of a bankruptcy debtor licensee under an executory licence and its licensor are not addressed by Section 365(n). The *Lubrizol* decision – which triggered Section 365(n) – and many of the early decisions involved bankruptcy debtors as licensors; thus this was the problem addressed by Section 365(n). Interestingly, early House drafts of Section 365(n) did address debtors as licensees, but these provisions were dropped. Thus, many of the most troubling disputes remaining involve licences to debtors. Courts must first determine whether a licence to a debtor is an executory contract or a sale.

Assumability

If the licence is executory, the Bankruptcy Code may permit its transfer without the licensor's consent. Section 365(f)(1) generally overrides bars on assignment. However, an important exception is found in 11 USC Section 365(c)(1), which forbids assignment of a contract where applicable non-bankruptcy law infers a bar on delegation even if the contract is silent – an explicit contractual bar is immaterial. This provision is known as the 'personal services' exception, as such contracts are the clearest example where the law will infer a ban on assignment. Pavarotti may not delegate to Smith his contract to sing even if the contract is silent. Such a contract may be assigned only if the non-debtor consents.

There is authority that many IP licences to debtors are such personal service agreements. Numerous decisions conclude that patent licences are non-assignable (see *In re CFLC, Inc 89*, F3d 673; *In re Sunterra Corp*, 361 F 3d 257; *Institut Pasteur v Cambridge Biotech Corp*, 104 F 3d 489 (1st Cir); see also *In re Alltech Plastics, Inc*, 71 BR 686 (Bankr WD Tenn 1987) and *Unarco Indus, Inc v Kelley Co*, 465 F 2d 1303, 1306 (7th Cir 1972) (both patent licences); *In re Patient Educ Media, Inc*, 210 BR 237 (Bankr SDNY 1997) (non-exclusive copyright licence); *Harris v Emus Records Corp*, 734 F 2d 1329 (9th Cir 1984) (copyright licence); *NCP Mktg Group, Inc v Blanks* (*In re NCP Mktg Group, Inc*), 337 BR 230 (D Nev 2005) (trademark licence)).

However, the *Pasteur* Case emphasises the limitations of this protection. In *Pasteur* a debtor in possession assumed a patent licence in its favour. Later the debtor sought to transfer its stock to the patent holder's major competitor through a plan of reorganisation. This was all the more unacceptable to the patent holder as the licence was extendable by its terms to affiliates of the licensee. The First Circuit rejected a challenge by the patent holder, ruling that there was no prohibited transfer of the licence. Noting that the debtor would continue its operations post-confirmation in essentially the same manner and with the same personnel as pre-petition, and that the licence had no change of control provisions, the court found the reorganisation within the fair contemplation of the licence. The *Pasteur* court contrasted the situation before it with that in *Alltech*, in which a trustee sought to sell the stock of a debtor corporation that had ceased all operations and become a shell holding only the subject patent licence. The *Alltech* court found this to be a forbidden assignment.

Can the debtor in possession assume the licence?

Under the literal terms of the statute, a bankruptcy debtor in possession not only is barred from assigning a personal contract without consent, but cannot even assume the contract and perform itself. The Ninth and Fourth Circuit Courts of Appeals, the Delaware Bankruptcy Court and other lower courts have held that not only may a debtor in possession not assign an IP licence in favour of the debtor without consent of the licensor, but it may not assume the licence without consent. In *Catapult Entm't, Inc v Perlman* (*In re Catapult Entm't Inc*) (165 F 3d 747 (9th Cir 1999); *RCI Tech Corp v Sunterra Corp* (*In re Sunterra Corp*), 361 F 3d 257 (4th Cir 2004)); *In re Access Beyond Techs*, 237 BR 32 (Bankr D Del 1999). In *Wellington Vision, Inc v Pearle Vision, Inc* (*In re Wellington Vision, Inc*) (364 BR 129 (SD Fla 2007)) the court applied this rule to bar assumption of a franchise agreement containing a patent licence.

Previous decisions not necessarily addressing intellectual property were split over whether to apply this bar literally. Some cases limit the bar to assignment or assumption by an independent trustee (eg, see *Pasteur*, looking to whether licensor receives "the benefit of its bargain"). Similarly, the Fifth Circuit rejected *Catapult*, adopting the so-called "actual test" permitting a debtor in possession to assume a non-assignable contract because no change of parties is involved (*Bonneville Power Admin v Mirant Corp* (*In re Mirant Corp*), 440 F 3d 238 (5th Cir 2006)). This test uses more policy than literal language of the statute.

Recently, one bankruptcy judge in the Southern District of New York concluded that the literal language of the code permits a debtor in possession to assume but not assign such a contract (*In re Footstar Inc*, 323 BR 566 (Bankr SDNY 2005)). However, his reading of the language appears strained. Some courts

have permitted assumption of non-IP personal agreements (see *In re Ontario Locomotive & Indus Ry Supplies (US), Inc,* 126 BR 146 (Bankr WDNY 1991); *In re Hartec Enters, Inc*, 117 BR 865 (Bankr WD Tex 1990), vacated, 130 BR 929 (WD Tex 1991); *In re Cardinal Indus, Inc*, 116 BR 964 (Bankr SD Ohio 1990)). However, a similar number have found the literal language of the statute to bar assumption of non-IP personal agreements (eg, see *In re West Elecs, Inc*, 852 F 2d 79 (3d Cir 1988); *In re Pa, Peer Review Org, Inc*, 50 BR 640 (Bankr MD Pa 1985); *In re Tonry*, 724 F 2d 467 (5th Cir 1984); see also *Transamerica Commercial Fin Corp v Citibank, NA* (*In re Sun Runner Marine Inc*), 945 F 2d 1089 (9th Cir 1991), addressing parallel provision re loan commitments).

Catapult and many of the bankruptcy cases address non-exclusive licences and expressly demur on application to exclusive licences. An interesting split of authority has arisen. In *In re Golden Books Family Entertainment, Inc* (269 BR 311 (Bankr D Del 2001)) the bankruptcy court found that under applicable non-bankruptcy law, an exclusive copyright licence conveyed a freely transferable ownership interest. The Copyright Act terms an exclusive licence a "transfer of ownership". Therefore, a bankruptcy debtor could freely assume and assign an exclusive licence over the licensor's objection. On the same day in the same case, the same judge found the debtor could not transfer a non-exclusive licence (*In re Golden Books Family Entm't, Inc*, 269 BR 300 (Bankr D Del 2001)).

However, the court's interpretation of applicable non-bankruptcy law's treatment of an exclusive licence is contrary to a more recent circuit court decision. In *Gardner v Nike, Inc* (279 F 3d 774 (9th Cir 2002)) the Ninth Circuit held in a non-bankruptcy case that an exclusive copyright licence could not be transferred without licensor consent, thus leaving the issue uncertain. The *Golden Books* court explicitly rejected the district court analysis affirmed in *Gardner*). Similarly, in *In re Hernandez* (285 BR 435 (Bankr D Az 2002)) the court found an exclusive patent licence non-assumable, although the patent law does not have the 'transfer of ownership' term of art found in the Copyright Act.

How a licensee should anticipate the non-assumability issue posed by *Catapult* is not clear. Legislative relief has not been enacted (106 HR 833 Section 365; 106 S 625). At a minimum, a licensee should seek explicit contractual provisions allowing assumption in bankruptcy. At least one case holds that this will work (*Metro Airports Comm'n v N Airlines, Inc* (*In re Midway Airlines, Inc*), 6 F3d 492 (7th Cir 1993)). The licensee should make sure the consent is to assumption explicitly. In *Sunterra* the licensor had consented to assignment, which the court presumes would be enforceable. However, because the consent did not address assumption – a prerequisite for assignment – the debtor's effort to assume and assign failed. A second alternative is use of a special purpose entity to hold the licence and to sub-license to the operating entity that by its operations may face a bankruptcy risk. A third possibility, suggested by some experts, is to permit the contract to ride through the bankruptcy without assumption or rejection. Such an approach would likely work only where the licensor is asleep and fails to file a motion to set a deadline to assume or reject. Finally, doing so might not avert a provision making the bankruptcy a default. For this last reason, the suggestion of abandoning the contract to the debtor (a different legal entity from the debtor in possession) is questionable.

Results of rejection

Licensee's rights

There are few reported cases addressing what rights, if any, a licensee retains if it rejects an executory licence. Debtor's counsel, arguing that a transfer has taken place and cannot be undone, will argue that the licensee retains its rights. This seems plausible if the licence bars non-monetary remedies to the licensor. Many copyright licences expressly provide that the licensor's only remedy in the event of the licensee's breach is an action for damages and waive any attempt to terminate the licence or interfere with the licensee's enjoyment. Such a provision is designed to address remedies upon default and arguably should survive the licensee's deemed default. Similarly, if the licence is truly a sale this analysis seems correct.

A fascinating recent decision in this regard is *Thompkins v Lil' Joe Records, Inc* (476 F 3d 1294 (11th Cir 2007)). In *Lil' Joe* the rap artist plaintiff had signed a contract with the defendant's predecessor under which the predecessor received "exclusive, unlimited and perpetual" rights in certain recordings, a half-ownership interest in some and a licence of unspecified nature was also granted in musical compositions. In return, the predecessor was to pay certain royalties. In the predecessor's bankruptcy, he first sought to assume and assign the agreements. He then changed course, rejected the agreements and sold all his rights to the defendant. The plaintiff failed to take any action – including filing a damage claim for rejection – until he sued the defendant six years later for infringement. The circuit court evaded the lower ruling in favour of the defendant on the grounds that the orders of the bankruptcy court were res *judicata* as to the issues and addressed the merits. It engaged in a *tour de force* of executory contract and IP issues. It started by noting that neither side addressed whether the contract was executory, but noted in passing that even if the artist or plaintiff had no continuing obligations under the Countryman test, the court might find executoriness under the functional test looking at what designation might benefit the estate. Concluding that executoriness would permit elusion of the payment obligations, the court suggests that it would have found executoriness under the functional test (Section 476 F 3d 1306 at n 13). Relying

on the well-established rule that rejection does not undo executed portions of a contract, the court ruled that ownership of the copyrights had already transferred to the defendant's predecessor and did not revert on rejection. As to the rights transferred "exclusive[ly], unlimited and perpetual[ly]" this seems clearly correct; the royalty payments were really a term purchase obligation. With regard to rights alleged to have been subject to a non-exclusive licence, the court finds the plaintiff failed to preserve his argument. *Lil' Joe* emphasised the need carefully to draft IP agreements to distinguish perpetual exclusive sales from non-exclusive finite licences – even in the context of rap music. However, *Lil' Joe* provided no clear guidance on the sticky issue of a non-perpetual but exclusive copyright licence discussed above.

Where the licence remains executory, strong arguments can be made that rejection terminates the licensee's rights. Rejection is deemed a breach by the debtor. Outside bankruptcy a licensee which commits a material breach can be denied continued enjoyment of the licensed property. Breach of the agreement can terminate its licence to use the other party's property. *Lubrizol* arguably supports such a result. In *Lubrizol* the licensor which was deemed to breach the contract was permitted to terminate the rights of the licensee. The rejection by a licensee – deemed to be a default by it – should have no less effect. In addition, the practical difficulty of requiring the licensor to prove the contingent liability for future royalties argues against giving it a mere claim in the bankruptcy. Many cases appear to assume without specifically addressing the issue that only assumption will permit the bankruptcy debtor to continue enjoyment of rights licensed to it under an executory contract (*Qintex*, 950 F 2d at 1495; AEG, 161 BR at 59). However, the rights of a licensee following rejection have not been clearly resolved.

Licensor's claim

Generally, a party which provides a valuable service or property to an estate during reorganisation is entitled to an administrative claim for the value of its contribution with a high priority for repayment. Practitioners have assumed this to apply to licence fees for use of intellectual property by a debtor in possession before rejection of the licence. When the licence is assumed, all payments must be made. Lessors of property are statutorily entitled to this protection. However, one Ninth Circuit decision casts doubt on this conclusion with regard to licensors of intellectual property. In *Microsoft Corp v DAK Industries, Inc* (*In re Dak Industries Inc*) (66 F 3d 1091 (9th Cir 1995)) Microsoft licensed a computer manufacturer to install a software program on the manufacturer's computers. The licence required the debtor to pre-pay for a guaranteed number of units, and for a per-unit royalty thereafter. Although the debtor never reached the pre-paid units, Microsoft presented an administrative claim for computers sold during the reorganisation.

This claim should have been rejected on the grounds that Microsoft had already received through its upfront payment compensation for every unit the debtor ever sold. Unfortunately, the court applied a different, disturbing analysis that will apply to many IP licences. The court emphasised the following points:

- The liability arose pre-petition, as the debtor was liable for the up-front minimum the moment it entered the contract;
- The licence fees were based on units sold, not time of enjoyment, which the court found made the agreement more like a sale than a lease (see *Prize Frize*, discussed above, where the court rejected a narrow definition of royalty limited to units sold, for a broader definition including time based compensation). Further, many 'plain vanilla' IP royalties are based on a unit enjoyment, not temporal enjoyment;
- The debtor obtained all its rights on entering the contract;
- The debtor was not the end user of the property, but conveyed it to others; and
- The licensor suffered no incremental burden from the debtor in possession's actions.

While the result in Dak seems correct, the reasoning is very dangerous for IP licensors, as many of these factors will apply to a typical licence. In *In re KMart Corp* (290 BR 614 (Bankr ND Ill 2003)) the court denied a licensor's motion for allowance of an administrative claim. However, the ruling relied on failure to show a benefit to the estate from the licensed software, strongly suggesting a different outcome on different facts.

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