APPENDIX 7 - EXCLUSIVE AND NON EXCLUSIVE LICENSES

Both the exclusive and nonexclusive licenses seem to be forms of personal property within the broad scope of U.C.C. sections 9-102 and 9-106.[1] When the debtor is the licensee, not the licensor, the licensor is the "account debtor." A licensor/account debtor is the person *obligated*, but the obligation is a performance obligation rather than a monetary obligation. The licensor "owes" the licensee/debtor forbearance from suit, as long as the debtor abides by the terms of the license. It is this contractual forbearance, which permits the licensee a limited use and gives value to the license as "intellectual property" while in the hands of the licensee.[2] However, the

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[1] U.C.C. § 9-102(1)(a) and § 9-106, cmt. ¶1. Revised Article Nine defers to "other law" on the issue of whether a particular debtor/licensee acquires "property" under a license of intellectual property. U.C.C. [Revised] § 9-408, cmt. 3. Cases involving private licenses are rare. *In re* Stirling Gold, Bankruptcy No. 77-B-1209 (Bankr. S.D.N.Y. 1980); (A license to distribute a film is a general intangible); Section 541(a)(1) of the Code does not make transferability a predicate to the definition of property which passes to the estate when the petition is filed. 11 U.S.C. § 541(a)(1). *See In re* Ryerson, 739 F.2d 1424, 1425 (9th Cir. 1984) ("...[T]he requirement that the debtor must be able to transfer the interest...has been eliminated under the Code.") Governmental licenses such as liquor licenses and water permits are often found to be general intangibles despite the control that the licensor can exercise over transfer. Bogus v. American National Bank of Cheyenne, 401 F.2d 458, 5 U.C.C. 937 (10th Cir. 1968); *In re* Dalcon, 120 B.R. 620, 13 U.C.C.2d 524 (Bankr. D. Ma. 1990); Lake Region Credit Union v. Crystal Clear Water, 502 N.W.2d 524, 21 U.C.C.2d 775 (N.D. 1993); Rushmore State Bank v. Kurylas, Inc., 424 N.W.2d 649, 6 U.C.C.2d 863 (S.D. 1988); Queen of the North, Inc. v. Legrue, 582 P.2d 144, 24 UCC 1301 (Ala. 1978). The result may be different if the state has specifically excluded such a license from the definition of "personal property." *In re* Sheldon, 1988 Lexis 1420 (Bankr. N.D. Ind. 1988). For a broad definition of "personal property" under U.C.C. section 9-102 see Travis v. Trust Company Bank, 621 F.2d 148, 150 (5th Cir. 1980). Priority between a secured lender and a nonexclusive license is not clearly covered under the priority rule in section 9-301(1)(d).

[2] The definition of an account debtor in U.C.C. § 9-105(1)(a) refers to "the person who is obligated on an account, chattel paper or general intangible." U.C.C. § 9-105(1)(a). *Accord* U.C.C. [Revised] § 9-102(a)(3). This language must be aimed at the person whose obligation gives the account, chattel paper or general intangible its value. Under the present language of Article 9, when intellectual property is licensed, both the licensor and the licensee are left with personal property in the form of a general intangible. The licensor owns an income stream and other contract rights on which the licensee is the "account debtor." If this income stream is not an account, chattel paper or instrument, it must be a general intangible. The licensee owns a right to use, and, in varying degrees, a right to insist on the licensor's forbearance. The licensor, therefore, should be viewed as the "account debtor" whenever the debtor is the licensee, because it is the licensor's obligation which gives the license its value in the hands of the debtor. The definition of "account debtor" could be read expansively, however, to cover *any person*, including the debtor obligated on a general intangible. In that case, a "debtor" using a license or permit

problem with unrestricted recognition of a debtor's licenses as collateral is found in the debtor's reciprocal obligations to the licensor/account debtor. Typically, the debtor is not able to transfer the license without the licensor/account debtor's consent. The debtor may have to use the license in a manner regulated by specific standards. For example, a franchisor of a retail chain or the governmental issuer of a broadcast license may want to control quality and, to that end, circumscribe certain actions of the actual owner of the store or the operator of the radio station. In order to assure that the licensor's control cannot be frustrated by a third party, the licensor may want to construe *any* attempted transfer, including one for security, as a breach of the license and grounds for termination.

The current Article Nine language in section 9-318(4) invalidates any contract term that "prohibit[s] assignment of an account or prohibits creation of a security interest in *a general intangible for money due or to become due* or requires the account debtor's assent to *such assignment or security interest*."[3] This language invalidates transfer restrictions, such as the prohibition in the franchise agreement set forth above. However, when the general intangible used as collateral is the income stream from the intellectual property, for example the franchise fees, Article Nine is silent on the validity of restrictions which benefit the licensor/account debtor when the licensee is the debtor and the collateral is the license itself. By negative inference from current section 9-318(4) such restrictions are effective. Therefore, the licensor can make the creation of a security interest in the license a breach of the agreement and thus grounds for terminating the license. Arguably, the licensor should not be able to frustrate the licensee debtor's legitimate interest in using a valuable license as collateral. Permitting the licensee to create a security interest in the license does not, until default, undermine the licensor's interest in deciding who should be able to exercise the rights granted under the license. It is only the secured party's unrestricted right to retain or dispose of the license *on default*, which undermines the licensor's legitimate right to control the licensee's identity.

In 1992, the Article Nine Study Committee recommended that:

"The Drafting Committee . . . give serious consideration to whether Article 9 should be revised to provide that a prohibition on the assignment of a private or governmental contract, license, or permit is ineffective to prevent the attachment or perfection of a security interest, and the creation of a

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as collateral could also be viewed as an "account debtor" in the same transaction because of the contractual or other restraints (e.g. assignment prohibited) which the licensee debtor owes to the third party licensor. *See* U.C.C. [Revised] § 9-408, cmt. 5. *See also* PEB Study Group Uniform Commercial Code Article, *Report* 178 (December 1, 1992).

[3] U.C.C. § 9-318(4).

security interest in the debtor's rights under the contract, license, or permit does not give rise to a default under the contract, license, or permit notwithstanding any agreement or other law to the contrary."[4] Section 9-408(a) of Revised Article Nine was drafted in response to the Study Committee's recommendation. The subsection renders "ineffective" anti-assignment and anti-collateral transfer language in a general intangible to the extent that such language "prohibits, restricts, or requires the consent of the... account debtor to the . . . creation . . . of a security interest."[5] The rule does not, however, make anti-assignment language ineffective to thwart assignments. Only when the language is used to prohibit transfers of security interests does the prohibition render the language ineffective. Nevertheless, to the extent that such restrictive language is "effective under other law," the security interest is (1) not enforceable against the account debtor, (2) imposes no duties on the account debtor, and (3) can be ignored by the account debtor.[6]

The Revision language does not really break from prior law on this point. The rule in Revised Article Nine generally follows an approach taken by some courts under current Article Nine. These courts have held that a security interest can be granted in a nontransferable governmental license, but "limited to the extent of the licensee's proprietary rights in the license vis a vis private third parties."[7] Thus, the secured party cannot realize on the security interest in the license unless the necessary foreclosure-related disposition has the approval of the licensor. Perhaps it also means that the secured party can assert no rights in the license property until an approved transfer of the property occurs. A typical security agreement prohibits the

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4 PEB Study Group Uniform Commercial Code Article, *Report* 178 (December 1, 1992).

5 U.C.C. [Revised] § 9-408(a). On default, Revised Article Nine section 9-607(a)(1) provides the secured party with a broadly defined right to "collect" an account debtor's "obligation." U.C.C. [Revised] § 9-607(a)(1). That post-default right to insist on an account debtor's contractual performance should yield to the limitations on any disposition of the debtor's license without licensor consent in Revised section 9-408(a).

6 U.C.C. [Revised] § 9-408(d). *See In re* CFLC, Inc., 89 F.3d 673 (9th Cir. 1996) ("A patent license is nonassignable as a matter of "federal common law.").

7 *In re* Ridgely Communications, Inc., 139 B.R. 374, 379 (Bankr. D. Md. 1992); *In re* Thomas Communications, Inc., 161 B.R. 621, 625-26 (Bankr. S.D. W.Va. 1993). There is considerable authority for the proposition that a patent license is a personal right not assignable absent the licensee's consent under the "applicable law" (i.e. the federal common law of patents) in section 365(c) of the Bankruptcy Code. *In re* CFLC, Inc., 89 F.3d 673, 679 (9th Cir. 1996); *In re* Alltech Plastics, Inc., 71 B.R. 686, 688-90 (W.D. Tenn. 1987); *In re* Patient Education Media, Inc., 1997 LEXIS 953 (Bankr. S.D.N.Y. June 30, 1997). However, a bankruptcy court has permitted the assignment of a trademark license, finding that "applicable law" was a narrow reference to personal service contracts. *In re* Rooster, Inc., 100 B.R. 228, 232-34 (Bankr. E.D. Pa. 1989).

unauthorized sale of the debtor's collateral. While such an unauthorized transfer by the debtor could be made an event of default, it is not clear that a secured party could enforce such a clause against a debtor who sought to transfer the license with the licensor's approval. All that may be left to a secured party with a security interest in the debtor's license is the right to the "proceeds" of a sale that is approved by the licensor.[8] When the account debtor/licensor terminates the debtor's license pursuant to terms other than those that are rendered "ineffective" by Revised section 9-408(a) and (c), the secured party does not appear to have a basis for objection. This conclusion seems to hold even when such a termination would be wrongful against the debtor.[9]

The Official Comment to Revised section 9-408 creates a curious limiting annotation on the statutory rule. The "ineffectiveness" language in Revised section 9-408(a) reaches those license terms that prohibit, restrict or require the consent of the licensor. The concept of a term that "restricts" the debtor/licensee's ability to create a security interest has been given a narrow (perhaps overly narrow) spin by the drafters of the Revisions in Official Comment 6. According to this Comment, a covenant in a license that merely "impairs" the licensee's ability to create a security interest is not rendered ineffective. Furthermore, a non-disclosure covenant only "impairs" the licensee who seeks to use the license as collateral—it does not "restrict."[10] Apparently, terms in the license that prohibit disclosure can be invoked by the licensor to prevent the licensee from furnishing a potential secured party with information about the intellectual property underlying the license. As a practical matter, this information is often critical to any valuation of the license as collateral, and thus critical to the creditor's decision to go forward with the requested secured loan.

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8 *In re* Thomas Communications, Inc., 161 B.R. 621, 625-26 (Bankr. S.D. W.Va. 1993).

9 *See* Capital Nat. Bank of New York v. McDonald's Corp., 625 F. Supp. 874, 42 UCC 1048 (S.D.N.Y. 1986).

10 U.C.C. [Revised] § 9-408(d), cmt. 6.