IDEA: The Journal of Law and Technology
1989

Commentary

CONGRESS PASSES NEW LEGISLATION PROTECTING LICENSEES OF INTELLECTUAL PROPERTY

Michael J. Shpizner

On October 18, 1988, President Reagan signed into law the Intellectual Property Bankruptcy Protection Act, Public Law No. 100-506 (the "Act"). This legislation is likely to have a significant impact on licensing transactions involving intellectual property. The purpose of this article is to provide a brief analysis of the Act, including (1) an overview of the legal background against which the Act was adopted; (2) a description of the operative provisions of the new law; and (3) conclusions and recommendations for dealing with the legislative changes.

I. Overview

The Intellectual Property Bankruptcy Protection Act is designed to counter the effects of a number of recent bankruptcy law cases dealing with intellectual property licenses, most notably Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043 (4th Cir. 1985). The Lubrizol case, and the United States Supreme Court's refusal in 1986 to review that decision, caused great concern throughout the intellectual property community. In that case, Richmond, the owner of a unique metal coating process, granted Lubrizol a nonexclusive license to use the technology. A year after the license was signed, Richmond went into bankruptcy. The trustee in bankruptcy, after determining that the technology could be more profitably exploited through other licenses, applied to the court for authorization to "reject" the license agreement. (Under the Bankruptcy Code (11 U.S.C. § 365), a trustee in bankruptcy is empowered, with court approval, to reject an executory contract if termination of the agreement would, in the trustee's opinion, benefit the debtor's estate.)

The Lubrizol court first held that the license agreement was executory, because both parties had continuing obligations under the contract. The court found the agreement to be executory on the part of the licensee, because Lubrizol was required to keep account records, pay royalties, and give sales reports. The agreement was executory on the part of the licensor, because Richmond had continuing duties to honor a "most favored licensee" clause, and to indemnify Lubrizol against infringement claims. Next, the court turned to the appropriateness of rejection. The *2 court ruled that in the absence of abuse of discretion or bad faith by the trustee, the court must accept the trustee's judgment that rejection of the license would be advantageous to the debtor. The court approved rejection of the license agreement, and Lubrizol was left with no rights to the technology, and only an unsecured claim against the debtor for breach of the license agreement.

The court in Lubrizol acknowledged that its decision imposed "serious burdens upon contracting parties such as Lubrizol," and even recognized that "allowing rejection in this and comparable cases could have a general chilling effect upon the willingness of such parties to contract at all with businesses in possible financial difficulty." Yet, the court ruled that its hand was forced under the Bankruptcy Code then in effect.

This and similar cases cast a shadow of uncertainty over the practice of intellectual property transfers. Some potential licensees, recognizing that they were unprotected against the possible bankruptcy of their licensor, began demanding that transactions be structured as complete sales or assignments, to avoid falling under the "executory contract" rubric. Other licensees began requiring complicated arrangements involving security interests, third party software escrows, and other largely untested attempts to thwart the bankruptcy trustee's rejection powers.

Congress acted quickly and firmly in support of the intellectual property license as a vehicle for furthering America's technology industry. The Act is intended to encourage the practice of technology licensing by ensuring that a licensee of intellectual property receives the benefit of its bargain, even after the licensor's bankruptcy. [n.a]

II. Operative Provisions Of The Act

The Act amends the Bankruptcy Code (11 U.S.C. § 101 et seq.) to add a new sub-section 365(n) regarding licenses of "intellectual property," defined to include copyrights, patents, trade secrets and mask works. The statutory definition of "intellectual property" does not include trademarks, trade names or related rights.

Under the Act, if the bankruptcy trustee rejects a license, the licensee, at its option, may either (A) treat the rejection as termination of the license agreement, and pursue an unsecured claim for breach [this remedy was available before the Act], or (B) retain its rights under the license (including exclusivity rights) for the duration of the contract. If the licensee elects to retain its rights under option (B), the licensee must continue to make royalty payments under the license agreement. A *3 licensee electing to retain its rights must waive any right of setoff it may have for damages resulting from the rejection, and any priority claim it may have arising from its performance under the contract.

A licensee retains only the rights that existed at the time of the licensor's bankruptcy filing. Thus, licensees are well-advised to ensure that the scope of the license granted when entering into the agreement covers such subject matter as source code and maintenance rights, even where actual delivery of the source code may occur only after filing. License agreement provisions that require delivery of source code or other intellectual property in the event of the licensor's bankruptcy are enforceable under the Act. The legislation provides that once a licensee opts to retain its rights, the trustee must turn over to the licensee any intellectual property (or embodiment thereof, such as source code stored on magnetic disk) held by the trustee. Moreover, such delivery may be pursuant to a collateral agreement: the trustee may not interfere with the licensee's right to obtain the intellectual property (or embodiment) from a third party, such as an escrow agent.

The Act also offers protection to the licensee during the period between the licensor's bankruptcy filing and the trustee's decision to reject the license agreement. Upon written request of the licensee at any time during this interim period, the licensor must either perform its obligations under the contract or turn over the intellectual property (including any embodiment) to the licensee. Also during this interim period, the licensor may not interfere with the licensee's rights under the agreement, including any right to obtain the intellectual property (or embodiment) from a third party.

It should be noted that, while the Act grants meaningful protection to intellectual property licensees, the statute represents a compromise between competing interests, and does not entirely nullify the trustee's rejection power. Although the licensor is prohibited from interfering with the licensee's exercise of its retained rights, the licensor is relieved of all affirmative obligations under the licensing agreement. Thus, the debtor/licensor need not perform such duties as maintenance, support, training, consultation, and providing upgrades and improvements. In many cases, the licensee's continuing rights to use the technology may be of little practical value without the licensor's ongoing support.

III. Conclusion/Recommendations

The legislation leaves a number of issues unresolved. For example, since trademark rights are not covered by the statute, how are licenses involving trademarks to be treated? What are the rights of a licensee under a distribution agreement granting rights to sublicense *4 the technology in conjunction with the licensor's trademark? Is the licensee granted an implied license to continue to use the mark? Is the licensee free to distribute the product under another mark? Or is the licensee effectively forestalled from exercising its retained rights under the Act's option (B)? None of these alternatives appears satisfactory; yet, the Act does not address this problem.

Another open question is the issue of the licensee's nonmonetary obligations under the license agreement. Under the Act, the only quid pro quo for the licensee's continued use of the technology is payment of royalties. Is the licensee released from all other obligations, such as confidentiality requirements, cross-licensing provisions, or marketing obligations? Does the result differ where the license provides that these obligations "survive" termination of the agreement?

The new law does not fully accomplish its stated goal of removing uncertainty and doubt from the practice of technology licensing. Accordingly, we generally advise the continued use of devices for minimizing the risks of licensor bankruptcy, such as security interests and third-party escrow arrangements. We encourage both licensees and licensors of technology to seek advice from counsel to develop strategies for protecting their intellectual property rights in light of this new legislation.

[n.a] The Act does not address the situation of a bankrupt licensee.