OVERVIEW OF INTELLECTUAL PROPERTY ISSUES IN AMERICAN INSOLVENCY CASES

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for

TAGLaw Budapest

Today's financial environment also serves as a reminder that the potential for a bankruptcy lurks around every corner of every transaction, particularly those involving intellectual property. A party to litigation may file for reasons unconnected to the pending litigation. A licensor of a copyright may find itself in financial difficulties. A licensee of a patent may hit a liquidity wall. Each of these situations has two things in common – financial turmoil and bankruptcy. The current financial markets make it clear that little can be done to inoculate against a potential bankruptcy so it is important to understand the consequences.

I. The Venue

A. Bankruptcy courts are divided into the same districts as District Courts within a particular state. The divisions may not be the same.

Bankruptcy courts fall under the jurisdiction of the United States District Courts ("District Courts"). As one would expect, each district and each judge within a division will have varying requirements and particularities. No decision of a district judge or a fellow bankruptcy judge is binding on a bankruptcy judge – which may (and often do) disagree.

II. The Players

A. Always with leading roles

1. The Debtor (and usually a/k/a the "Debtor-in-Possession" or DIP)

2. The United States Trustee (not to be confused with a "trustee")

The non-bankruptcy lawyer may find it difficult at first to grasp the nuances. For example, if a petition is filed instituting a Chapter 7 case (liquidation), a trustee is appointed at the beginning of the case. If a Chapter 11 (in order to reorganize) is filed, a "debtor-in-possession" is created. Unless otherwise specified, the Bankruptcy Code (as well as these materials) uses the terms "trustee," "debtor" and "debtor-in-possession" interchangeably. With certain limited exceptions, Section 1107(a) of the Bankruptcy Code gives a debtor-in-possession "all the rights, . . . and powers, and shall perform all the functions and duties, . . . of a trustee . . ." Generally, a person or organization that files a bankruptcy petition transforms into a "new" entity which has the power (a) of a bona fide purchaser (regardless of any actual knowledge of the debtor), (b) of a judicial lien creditor (even if none exist), and (c) to recover monies paid or property transferred within certain periods. This transformation is at the heart of a reorganization – and can be a very frustrating experience for a creditor.

It is also confusing as there is a United States Trustee (an arm of the Department of Justice), which appoints Chapter 7 Trustees, Chapter 7 and Chapter 13 trustees and sometimes a Chapter 11 Trustees, if so ordered by the Court.

B. Usually have a leading role

1. Secured Creditors

2. The Creditors Committee

The Creditors' Committee: The Bankruptcy Code provides for the appointment of an "official" committee to represent the interests of unsecured creditors under Chapter 7 and Chapter 11. In a Chapter 7, there often is little distribution to unsecured creditors and thus no need for an unsecured creditors' committee. In a Chapter 11, however, a creditors' committee often plays an important role.

In a Chapter 11, a creditors' committee may:

(a) Consult: with the trustee or the debtor-in-possession concerning the administration of the case;

(b) Investigate: the conduct and financial affairs of the debtor, investigate the operation of the debtor's business, and determine the desirability of continued operations;

(c) Participate: in the formulation of a plan of reorganization and make recommendations concerning the plan; and

(d) Request: the appointment of a trustee or examiner if circumstances warrant it.

In some Chapter 11 cases, there may be multiple creditors committees and, if it appears there may be return for equity, an equity committee.

C. Sometimes have roles

1. A Trustee

2. An Examiner

3. Ad Hoc Committees

4. Financial Advisors

In all cases under Chapter 7, Chapter 12 and Chapter 13, a trustee is appointed to administer the property of the estate according to the provisions of the particular chapter under which relief has been ordered. A trustee is appointed in a Chapter 11 case only on the request of a party-in-interest and after notice and hearing by the court. If a trustee is appointed, a new party is added to all pending litigation. A trustee may seek appointment of its own counsel who may not be the counsel who previously represented the debtor in the pending litigation. All pending causes of action "belong" to the trustee. This is extremely important in the context of settling litigation. The duties of the trustee vary depending on the chapter of the Bankruptcy Code under which relief has been ordered.

III. The Source Document – the United States Bankruptcy Code 11 U.S.C. §§ 101, *et seq.*

A. The Bankruptcy Code is divided into eight chapters

1. Chapters 1, 3, and 5 contain general provisions that are potentially applicable in all bankruptcy cases.

2. Chapters 7, 9, 11, 12 and 13 contain provisions particular to the various types of bankruptcy cases and provisions within those five chapters generally apply only to relief sought under that particular chapter. There are, of course, exceptions.

3. Chapter 11 provides for a reorganization but often includes a sale or liquidation.

Chapter 1 of the Bankruptcy Code contains definitions and other general provisions.

Chapter 3 governs case administration, including the commencement of a case, some parties to a bankruptcy case and the administrative powers of a bankruptcy court.

Chapter 5 deals with the relationship between creditors, the debtor and the bankruptcy estate.

Chapter 7 governs the traditional liquidation bankruptcy during which the debtor's non-exempt assets are sold or otherwise disposed of all to satisfy the claims of creditors.

Chapter 9 contains the provisions dealing with the adjustment of debts of a municipality or other taxing authority.

IV. The Estate

A. The commencement of a bankruptcy case creates an estate comprised of all legal or equitable interests of the debtor in property wherever located.

B. Property recovered pursuant to certain sections of the Bankruptcy Code also becomes property of the estate.

V. Automatic Stay

A. The automatic stay is an integral part of the Bankruptcy Code. The automatic stay prevents the chaotic and uncontrolled scramble for a debtor's assets by creditors. The purpose of the stay is to preserve the status quo.

B. State and Federal Courts have concurrent jurisdiction to decide effect of the stay.

C. The automatic stay protects both debtors and creditors because: (1) it gives the debtor a breathing spell from his creditors – it stops all collection efforts, all harassments and all foreclosure actions and it permits the debtor to attempt a repayment or reorganization plan or simply to be relieved of the financial pressures that drove him into bankruptcy; and (2) the automatic stay provides creditor protection. Without it, certain creditors would be able to pursue their own remedies against the debtor's property. Those who acted first would obtain payment of the claims in preference to and to the detriment of other creditors. Bankruptcy is designed to provide an orderly liquidation procedure under which all creditors are treated equally.

D. The effect of the automatic stay on pending litigation is often confusing.

1. The first step is to determine the original posture of the pre-petition action – if the action was commenced against the debtor, as a general rule, it is stayed regardless of its current posture.

2. If the debtor is the plaintiff and if there are no counterclaims seeking affirmative relief, the pre-petition action is <u>not</u> stayed.

3. The automatic stay does not bar a party from commencing an adversary or contested proceeding against the debtor in the bankruptcy court.

4. The majority of courts have held that violations of the stay are void *ab initio.* This can be a significant distinction for litigation. However, in *Picco v. Global Marine Drilling Co.,* the Court of Appeals for the Fifth Circuit held that an action commenced during the pendency of the automatic stay was <u>voidable</u>, not void – clearly a minority position. Some courts have found a middle ground by holding that an order lifting the stay can be entered *nunc pro tunc.*

5. Stay Against Co-Debtors - Unless the debtor files a petition under Chapter 12 or Chapter 13, a creditor is not automatically stayed from pursuing its claims against co-debtors, including guarantors, affiliates or subsidiaries.

VI. Contracts

A. Assumption or Rejection

While the debtor is given the opportunity to assume or reject contracts, it is important to recognize that assumption or rejection of a contract must be made with respect to the entire agreement. *See In re Audra-John Corp.*, 140 B.R. 752 (Bankr. D. Minn. 1992) (citing cases). Partial assumptions or assumptions of select provisions of an agreement are not authorized and the trustee or DIP assumes or rejects unexpired agreements in their entirety. *Century Indem. Co. v. NGC Settlement Trust (In re National Gypsum Co.)*, 208 F.3d 498, 506 (5th Cir. 2000). In this context, it is often stated that the trustee or DIP has to assume the agreement or reject the agreement in its entirety, with both its benefits and its burdens. *See, e.g., City of Covington v. Covington Landing L.P.*, 71 F.3d 1221 (6th Cir. 1995). On the other hand, if the agreement contains separate, severable agreements, the debtor may reject some, but not others; rejection does not require rescission of executed portions. *Stewart Title Guar. Co. v. Old Republic Nat'l Title Ins. Co.*, 83 F.3d 735 (5th Cir. 1996); *In re Adelphia Bus. Solutions, Inc.*, 322 B.R. 51 (Bankr. S.D.N.Y. 2005) (citing numerous cases).

B. Ipso Facto Clauses

Section 362 of Bankruptcy Code needs to be read in tandem with section 365 of the Bankruptcy Code. One issue that often arises when a party files bankruptcy is the non-debtor, upon reviewing its contract, desires to enforce an *ipso facto* provision to the effect that the contract is automatically terminated, if the other party files bankruptcy. Such provisions are unenforceable under section 365(e)(1) of the Bankruptcy Code. 11 U.S.C. § 365(e)(1).

Section 365(e)(1) does not serve as a basis for revival of a contract terminated prior to the bankruptcy filing. *See, e.g., Comp III, Inc. v. Computerland Corp.*, 136 B.R. 636 (Bankr. S.D.N.Y. 1992). As noted by another court, where the debtor breached a contract and the contract was actually terminated as a result of the breach, the termination is valid. *Nemko, Inc. v. Motorola, Inc., (In re Nemko, Inc.)*, 163 B.R. 927 (Bankr. E.D.N.Y. 1994).

C. Cure Claims

If the debtor is in default, a condition to assumption of a contract is a requirement that all defaults must be "cured" and a showing of adequate assurance of future performance. *In re Rachels Industries, Inc.*, 109 B.R. 797 (Bankr. W.D. Tenn. 1990). What constitutes adequate assurance of future performance is decided on a case-by-case basis. *See, e.g., In re Texas Health Enters.*, 246 B.R. 832 (Bankr. E.D. Tex. 2000). The courts state that adequate assurance of future performance is generally less than an absolute guarantee of performance. The courts often refer to simply a showing by the debtor that its financial condition reflects an income stream and financial strength sufficient to meet the debtor's contractual obligations that the general economic outlook in the debtor's industry is sufficient for debtor to operate and, to the extent applicable, that a guarantee of obligations by a liquid third party exists. *See In re Carlisle Homes Inc.*, 103 B.R. 524, 538 (Bankr. D.N.J. 1988).

VII. Intellectual Property Issues

A. Intellectual property is defined to include patents and copyrights and essentially excludes trademarks. 11 U.S.C. § 101(35A)

B. Debtor as Licensor

1. If Debtor elects to reject license, Licensee may. *Id.* § 365(n).

(a) Elect to treat the license as terminated and assert claim for rejection damages. *Id.* § 365(n)(1)(A).

(b) Retain its nonexclusive intellectual property rights "as such rights existed" immediately before the bankruptcy case. *Id.* § 365(n)(1)(B).

2. No guarantee of rights to improvements. *See id.*

3. Must continue to make royalty payments. *Id.* § 365(n)(2).

4. Trademark Licensees may not have the same protection. *See, e.g., In re Gucci,* 126 F.3d 380, 394 (9th Cir. 1997).

C. Debtor as Licensee

1. Exclusive license

(a) Debtor has a property interest, and therefore has the right to assign and transfer to a third party subject to applicable non-bankruptcy law. *See generally In re Golden Books Family Entertainment, Inc.*, 269 B.R. 300, 308-309 (Bankr. D. Del. 2001); *but see Gardner v. Nike, Inc.*, 279 F.3d 774, 781 (9th Cir. 2002) (holding, outside of the bankruptcy context, that an exclusive copyright license was unassignable).

2. Non-Exclusive license

(a) May not be assigned without consent of the owner of the intellectual property. 11 U.S.C. § 365(c).

(b) Disagreement between the Circuits concerning whether a debtor may assume a non-exclusive license without the consent of the owner where the license will not be assigned to a third party.

(1) Hypothetical Test: If applicable non-bankruptcy law would forbid an assignment to a third party, then the debtor in possession may not assume the license without the owner's consent. *RCI Tech. Corp. v. Sunterra Corp., (In re Sunterra Corp.)*, 361 F.3d 257 (4th Cir. 2004); *In re Catapult Entertainment, Inc.*, 165 F.3d 747, 754-55 (9th Cir. 1999); *City of Jamestown v. James Cable Partners, L.P., (In re James Cable Partners, L.P.)*, 27 F.3d 534, 537 (11th Cir. 1994); *In re West Elecs., Inc.*, 852 F.2d 79, 83 (3d Cir.1988).

(2) Actual Test: If the debtor in possession does not intend to assign the license to a third party, then the owner's consent is not required for the debtor in possession to assume the license. *Matter of Mirant Corp.*, 440 F.3d 238, 248 (5th Cir. 2006); *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489, 493 (1st Cir. 1997), *abrogated on other grounds by Hardemon v. City of Boston*, 144 F.3d 24 (1st Cir. 1998).