Structuring License Agreements with Companies in Financial Difficulty--Section 365(n)--Divining Rod or Obstacle Course?

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In 1988, Congress enacted the Intellectual Property Licenses in Bankruptcy Act (the "Act"). The purpose of the Act was to protect licensees from loss of their vested research, development, manufacturing, and marketing interests in intellectual property when a licensor files a petition for relief under the United States Bankruptcy Code (the "Code"). Congress believed, and rightly so, that absent legislation, the debtor's ability to reject a license agreement as an executory contract would have a "chilling effect" on the development of intellectual property. Accordingly, it adopted legislation that modifies section 365 of the Code, which governs the debtor's right to assume or reject executory contracts and unexpired leases, by allowing licensees to contract for significant deviations from rights previously granted debtor-licensors under the Code. In fact, the Act authorizes licensees to enter into agreements with financially troubled licensors of intellectual property, eliminating the "cornerstone" rights typically afforded to debtors.

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2 The disincentives to dealing with financially-troubled licenses include the inability to use intellectual property after the filing date and the potential elimination of negotiated terms of the license agreement, including trade secrets, exclusivity, and escrow provisions.

3 See S. Rep. No. 100-505, 100th Cong., 2d Sess. 8-10, reprinted in 1988 U.S. CODE CONG. & ADMIN. NEWS 3200, 3205-08 [hereinafter S. Rep.]. These cornerstone rights include the following: (1) the debtor's right to stay proceedings which seek possession or control of property of the estate; (2) the debtor's right to assume or reject executory contracts; (3) the debtor's and creditor's right to notice and a hearing prior to obtaining or transferring assets of the estate; and (4) the debtor's right to avoid enforcement of ipso facto clauses. Id.; see
The Act, unlike the other sections of the Code, can only be enforced if an agreement detailing the licensee's rights in the event of the licensor's bankruptcy exists prior to the bankruptcy filing and if the licensor rejects the license agreement as an onerous executory contract. Absent an agreement protecting the licensee's vested right to use intellectual property in the event of the licensor's bankruptcy, the licensor may reject the license agreement and eliminate any vested rights held by the licensee. Although an agreement protecting the postbankruptcy rights of the licensee is essential to the licensee's ability to enforce the Act, neither the Act, the legislative history, nor judicial authority provide licensees with guidance for drafting such agreements.

This Article examines the case law decided prior to the enactment of the Act, the legislative intent of its enactment, and the Act's provisions in order to determine whether the Act provides licensees with a true road map for drafting license agreements, or rather, an obstacle course fraught with potential litigation issues. During our journey through the provisions of section 365(n), we will provide the licensee with drafting suggestions to expedite the bankruptcy process. In addition, we will point out potential obstacles from which may emerge preference, fraudulent transfer, bankruptcy, and criminal litigation. Finally, since the Act only allows the licensee to structure agreements that protect it from debtors who reject license agreements as executory contracts, we will discuss what may be the licensee's worst nightmare—assignment of the license agreement to an undesirable business partner.

I. PRE-ACT PRECEDENT—CONFLICTING TREATMENT OF LICENSE AGREEMENTS UNDER SECTION 365(a) OF THE CODE

Section 365(n) was incorporated into the Code provisions covering the assumption and rejection of executory contracts to counteract the "chilling effect" that the rejection of contracts has on the development and marketing of intellectual property. This chilling effect was recognized by several courts as the inability of licensees to protect their business interests when they became "technology-dependent" upon a bankruptcy licensor. These courts urged legislative reform. As the provisions stood, these courts


* See infra notes 8-19 and accompanying text (case law favoring bankrupt licensors
were compelled to reject all vested rights in technology held by licensees, even if the effect was to bankrupt the licensee or to discourage venture capitalists from investing in high technology. Although this viewpoint has merit, other courts have recognized that, notwithstanding the executory nature of license agreements, equitable procedures may be fashioned that effectively protect the licensees' right to use intellectual property critical to its operations. To understand the motivation of the Act's drafters and its industry supporters, prior case law on both sides of the issue should be examined.

A. Case Law That "Chilled" the Development of Intellectual Property

Congress cited Lubrizol Enterprises v. Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.), as a catalyst for the Act. In Lubrizol, the Court of Appeals for the Fourth Circuit held that absent statutory modification, the bankruptcy courts must unconditionally reject license agreements for intellectual property. Accordingly, the Lubrizol court called upon Congress to modify section 365 of the Code to protect licensees from loss of their vested interest in intellectual property caused by a debtor-licensor's rejection of a license agreement. A discussion of the hardship that the court felt compelled to inflict upon the licensee will illustrate whether it was the rejection of the license agreements or the failure of the courts to fashion equitable remedies that had a "chilling effect" on the development of intellectual property.

In Lubrizol, the licensee Lubrizol entered into a license agreement with the debtor that authorized Lubrizol's nonexclusive use before enactment of § 365(n)).

See infra notes 20-29 and accompanying text (case law favoring licensees before enactment of § 365(n)).

See S. REP., supra note 3, at 2. It is apparent from the legislative history that the drafters of the Act were assisted by high-technology and business lobbyists concerned with the risks of dealing with start-up companies. The author believes that the effect of this lobby may have been to disregard, to some extent, the interests of licensors.


Id. at 1046.

Id. at 1048.

See id. The Lubrizol court noted that allowing rejection in such cases could have a "general chilling effect upon the willingness of such parties to contract at all with businesses in possible financial difficulty." Id.
of a metal-coating technology. This technology was the backbone of Lubrizol's business. Nevertheless, the Fourth Circuit, in affirming the decision of the Bankruptcy Court for the Eastern District of Virginia, held that rejection of the license agreement was a sound exercise of the debtor's business judgment. Indeed, the metal-coating process that was subject to the licensing agreement was the debtor's principal asset. Therefore, the unfettered sale or licensing of that technology represented the primary source of funds that would enable the debtor to emerge from bankruptcy.

In holding that the debtor's unilateral rejection of the license agreement was a valid exercise of business judgment, the court observed that section 365 did not authorize the court to weigh the potential harm to the licensee. Therefore, absent modification of the Code, debtor-licensors may reject licenses of intellectual property as executory contracts and eliminate the licensee's right to use the intellectual property and to enforce trade secret, exclusivity, and escrow agreements. The Lubrizol court acknowledged that its decision would have a "chilling effect" on the development of intellectual property and would result in ruination of the licensee's business; nevertheless, it held that section 365 mandated rejection of the license. Accordingly, the Fourth Circuit called upon Congress to rectify this problem.

Similarly, in In re Logical Software, Inc., the bankruptcy court affirmatively rejected the argument that the debtor's ability to exercise its business judgment by rejecting a license agreement should be subject to a balancing of the equities between the debtor's and the licensee's best interest. Instead, the court authorized the rejection of a license agreement for computer software, even though the licensee's business was based entirely upon its use of the debtor's software and the surrender of a supple-

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\[\text{id. at 1047-48.} \]

\[\text{See id. at 1047; see also In re Logical Software, Inc., 66 Bankr. 683, 687 (Bankr. D. Mass. 1988) (court allowed debtor to reject exclusive license even though rejection resulted in complete ruin of licensee); In re Laser Disc Computer Sys., Inc., No. 85-00535-L, slip op. at 6 (Bankr. D. Mass. Oct. 8, 1985) (court allowed debtor to reject exclusive license of software under business judgment test).} \]

\[\text{Lubrizol, 756 F.2d at 1048.} \]

\[\text{See id.} \]

\[\text{Id. The court stated that "Congress has plainly provided for the rejection of executory contracts, notwithstanding the obvious adverse consequences for contracting parties thereby made inevitable." Id.} \]

\[\text{66 Bankr. 683 (Bankr. D. Mass. 1988).} \]

\[\text{id. at 687.} \]
mental code developed by the licensee.\textsuperscript{19}

\textbf{B. Case Law That Balanced Equities Between Creditor Interests and Fostering the Development of Intellectual Property}

Although the legislative history conveys the impression that courts did not recognize the licensees' vested rights in the intellectual property prior to the Act, in reality, this nonrecognition was not completely true.\textsuperscript{20} For example, in \textit{Fenix Cattle Co. v. Silver (In re Select-a-Seat Corp.)},\textsuperscript{21} the Court of Appeals for the Ninth Circuit balanced the equities between the debtor-licensor and the solvent licensee. Unlike \textit{Lubrizol}, the \textit{Silver} court did not require the licensee to return the technology after rejection of the technology license.\textsuperscript{22} As a result, the rejection merely eliminated the license provisions regarding exclusivity and the licensor's continuing warranty obligations.

Similarly, in \textit{In re Petur U.S.A. Instrument Co.},\textsuperscript{23} the bankruptcy court balanced the benefit that the bankrupt estate derived from the rejection of the contract against the potential harm suffered by the licensee. In \textit{Petur}, the license provided that, in the event of bankruptcy, Petur, U.S.A. was to provide Petur, Canada with the following: (1) certain techniques and skills regarding the technology; (2) the right to sell its inventions to Petur, Canada at a certain percentage of production cost; (3) sixteen hours of consulting services per month; and (4) a promise to refrain for twenty years from licensing its technology to another company for use in Canada.\textsuperscript{24} The debtor sought to reject the license in order to relicense the product in Canada. The court determined that the rejection could be allowed only if the benefit to the estate's unsecured creditors outweighed the potential harm to the licensee.\textsuperscript{25} Accordingly, the court denied the rejection of the contract because there was no evidence that the potential increased income from the rejection would materialize.\textsuperscript{26}

\textsuperscript{19} Id. at 685.
\textsuperscript{21} 625 F.2d 290 (9th Cir. 1980) (per curiam).
\textsuperscript{22} Id. at 292.
\textsuperscript{24} Id. at 562.
\textsuperscript{25} Id. at 563-64.
\textsuperscript{26} Id. at 564.
In *Robertson v. Pierce (In re Huang)*, the court also applied a balancing test and rationalized that it is proper for the court to refuse to authorize rejection of a lease or executory contract where the party whose contract is to be rejected would be damaged disproportionately to any benefit to be derived by the general creditors of the estate as for example where most of the “benefit” of rejection of the contract would be captured by a third party at the expense of the unsecured creditors.

Taken together, these cases clearly demonstrate that it is possible for courts to fashion equitable remedies that protect the bankrupt’s right to reject the license agreement without irreparably damaging the livelihood of the licensee. Such judicial remedies have a great advantage over any statutory enactment because these remedies are not dependent upon the express terms of the license agreement. Moreover, courts can limit the protections afforded licensees to those that enforce the licensees’ vested rights to jointly developed technology, specialized technology, or hardware developed for use in conjunction with the licensed technology, while disregarding the perhaps overreaching terms of the license agreement. Indeed, even though the Act gives licensees broad powers to structure terms of license agreements to survive rejection under section 365(a), courts will still be called upon to enforce these agreements. In doing so, they may apply the equitable remedies fashioned by the courts in *Select-A-Seat, Petur*, and *Huang*.

C. A Nonstatutory Solution—Contractually Separating Vested Technology Rights and Executory Obligations

Commentators have observed that the Act would have been unnecessary if contracts such as license agreements were viewed as an exchange of two assets: (1) the executory rights and obligations

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27 23 Bankr. 798 (Bankr. 9th Cir. 1985).
28 Id. at 801.
29 The legislative history appears to encourage judicial scrutiny of license agreements. See, e.g., H.R. Rep. No. 1012, 100th Cong., 2d Sess. 7 (1988) [hereinafter H.R. Rep.] (“HR 5348 does not change the requirement under § 365(a) of the Bankruptcy Code (11 U.S.C. § 365(a)) that a trustee’s decision to reject an executory intellectual property license agreement is subject to court approval”); S. Rep., supra note 3, at 9 (“This bill is intended to restore confidence in the system of intellectual property licensing, and courts interpreting it should be sensitive to the reasonable practices that have and will evolve among parties seeking to add to the technological and creative wealth of America.”).
STRUCTURING LICENSE AGREEMENTS

under the license agreement; and (2) the licensor's vested property right in the underlying technology. Because executory contracts, as defined by Professor Countryman, are contracts in which performance remains due on both sides, it follows that rights in the underlying intellectual property cannot be "rejected" because these rights ceased to be executory contractual obligations at the inception of the license. Rather, these rights vested when the technology was transferred from the licensor to the licensee. Under this analysis, a debtor may either assume or reject the executory rights and obligations under the license agreement, such as the duty to provide system support or maintenance, without affecting the vested rights and legal obligations of the parties in the underlying intellectual property.

This characterization of a license agreement is appropriate in the area of intellectual property because in that discipline licenses generally involve two considerations:

(1) the delivery or promise to deliver products from the manufacturer to the marketing agent under terms that may or may not convey ownership of the product; and

(2) an agreement by the marketing agent to promote, distribute, or use the product within specified restraints, making payments to the original owner.

Clearly, the preceding analysis requires that every license be examined to determine whether the parties intended to convey a vested property right. For example, when a tear-away license for a computer game is given to one million teenagers who own personal computers, it would be ridiculous to assert that the debtor-licensee may reject the license agreement because the contract is executory in nature. In that situation, it is obvious that an executed transfer

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31 Countryman, Executory Contracts in Bankruptcy: Part I, 57 MINN. L. REV. 439, 460 (1973). Countryman, in his frequently cited law review article, defines an executory contract as "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute material breach excusing the performance of the other." Id.

32 See, e.g., In re Prime Motor Inns, 124 Bankr. 378, 383 (Bankr. S.D. Fla. 1991) (granting debtor's motion to reject executory management agreement, but requiring new agreement to include certain provisions); Zenith Laboritories v. Security Pac. Nat'l Trust (In re Zenith Laboritories, Inc.), 104 Bankr. 667, 672-73 (Bankr. D.N.J. 1989) (bondholders may declare debtor in default and draw upon letter of credit upon filing bankruptcy petition because agreement which triggered liability was not executory contract).

of ownership rights was intended. Conversely, when a license for use of a process is granted to a manufacturer so that it may use this process in its day-to-day business operations, a question arises as to what ownership rights were intended to be conveyed as part of the license.

To determine whether a license or a portion thereof should be treated as an executory contract when a party to the license files for bankruptcy, it is argued that the conveyance of the indicia of ownership should be governed by the definition of property under section 541 of the Code. This definition is much broader than the definition applied in copyright or patent license contracts because it includes "all legal and equitable interests of the debtor [and perhaps the non-debtor under 365(n)] in property." Under this definition, the licensee most certainly has an interest in the property. Indeed, this equitable interest is more substantial if the licensee's entire business is based upon use of technology or incorporation of the technology into a finished product for resale to third parties.


Id. § 541(a)(1). This contention is supported by the legislative history which provides the following clear statement of intent:

The bill provides for treatment of intellectual property licenses under Section 365 in a manner that parallels generally the treatment of real estate leases in the existing provisions of Section 365(h)(1). While intellectual property plays a unique role in technological and economic development, the problems associated with rejection of executory contracts are common with other special forms of property, such as real property leases. In both real estate leases and intellectual property licenses, the underlying property is unique. When the lessee or the licensee is threatened with loss of use of the property, it is not possible to obtain precise cover from another source.

In adopting the Code, Congress recognized this problem with respect to real property leases and enacted Section 365(h). That section clarified that, although a bankrupt lessor could avoid performance of future obligations under an unexpired lease, it could not cause through rejection of the lease an innocent lessee to forfeit the remainder of its leasehold. Neither the bar nor Congress then foresaw the need to protect similarly the reasonable expectations of intellectual property licensees. The bill corrects the perception of some courts that Section 365 was ever intended to be a mechanism for stripping innocent licensee of rights central to the operations of their ongoing business and stripping the American licensing system of its dependability and flexibility. Thus, the bill does not accord special treatment for intellectual property or the interests of its licensors or licensees beyond that which Congress has recognized in the past is required for these other unique property rights. The bill recognizes that there may be circumstances in which the future affirmative performance obligations under a license cannot be performed in a manner that benefits the estate, but limits the consequences of the breach or rejection of the contract.

S. Rep., supra note 3, at 4-5 (emphasis added).
The legislative history clearly provides that if technology is critical to the continued operation of a licensee’s business, and the royalties are substantial enough to reflect a purchase of an interest in intellectual property, a property right has been transferred.\textsuperscript{38} To protect this property right and effectuate a complete transfer of legal and equitable interest in the intellectual property, the license agreement must define the irrevocable rights transferred at the inception of the agreement, the consideration given for this property right, and the remedies available upon default. These rights should be secured by the intellectual property as collateral or by a letter of credit that can be drawn upon in the event of a default.\textsuperscript{37}

II. CONGRESSIONAL REACTION TO THE CONFLICTING TREATMENT OF LICENSE AGREEMENTS UNDER SECTION 365(a)

In 1988, Lubrizol and its progeny were brought to the attention of the judiciary committees of the House and Senate. After hearings attended by members of the bankruptcy bar and technical community, Congress concluded that the then-existing precedents were insufficient to protect and foster the development of intellectual property. Accordingly, Congress accepted the recommendation of the Lubrizol court\textsuperscript{38} and enacted legislation designed to protect licensees and thereby encourage technological innovation.

A review of the legislative history indicates a Congressional awareness that the tension between the federal policies underlying the Bankruptcy Code, and those behind the Patent Code and Copyright Act, necessitated modification of the Code. For example, one of the policies behind the copyright and patent laws is encouragement of access to intellectual properties through the payment of royalties. Absent legislation, the right to reject a license agreement would give debtor-licensors a stronger monopoly than the drafters of the patent or copyright laws had ever intended because

\textsuperscript{36} A comparison of 11 U.S.C. § 365(h), (i), and (n) reveals that Congress sought to give lessees and licensees the right to exercise property rights enjoyed by debtors under the Code. Specifically, the right to assert their equitable interest in the property that has been leased or licensed from the debtor. See 11 U.S.C.A. § 365(h), (i), (n) (Supp. 1991).

\textsuperscript{37} As a counterpoint, it should be noted that this thesis, as applied to licenses of intellectual property and leases of real and personal property, may give bankrupts more extensive property rights than those contemplated or authorized under common law. Indeed, the purpose of licenses and leases is that possession of real or intellectual property be transferred, but that title remain with the transferor.

\textsuperscript{38} See Lubrizol, 758 F.2d at 1048.
it would allow the licensee the unilateral right to withhold its technology from the marketplace.

Consequently, the drafters limited the traditional powers of debtors to obtain relief from onerous contracts, acknowledging that although it is important to protect debtors from onerous contracts, it is equally important for Congress to promote technological development and innovation by protecting the rights of nonbankrupt licensees.39

A. The Economic and Public Policy Issues Addressed Under the Act

In enacting section 365(n), Congress recognized that technological development and innovation are advanced by encouraging solvent licensees to invest in start-up companies. Indeed, the economic reality is that intellectual property is often developed by undercapitalized companies relying on the financial support of solvent licensees to provide "venture capital" for development. To encourage investment in intellectual property and to protect the rights of the licensees who contribute financing, research, development, manufacturing, or marketing skills, Congress limited the power of debtor-licensors to "reject" licenses as executory contracts.40

As the judiciary committees observed, it would be inequitable if a licensee who funded the development of the intellectual property, or who invested substantial monies in anticipation of using or marketing the technology, were denied the benefit of its bargain.41 It would also be unjust if the debtor or creditors' committee could unilaterally disclose jointly developed trade secrets, patents, or copyrightable information.42 Such disclosures would have a devastating effect on the licensee's business, possibly even causing its bankruptcy.43 The judiciary committees compared the licensee's predicament to that of a lessee of real property because in both

40 Id. at 4-5.
41 Unfortunately, both the Senate and House Reports are silent about the funds that the debtor-licensor may have lost in an effort to comply with its contractual obligations or the possibility that the licensee's investment in the debtor's software is secured by a lien against the debtor's property.
43 See id. at 3 (upon licensor's rejection of agreement, licensee loses right to continued use of intellectual property).
instances the consequences of the debtor's breach is not compensable in monetary damages.\textsuperscript{44}

\textbf{B. The Congressional Reaction}

To prevent these consequences and encourage public investment in intellectual property, Congress modified section 365 of the Code to enable the licensee to structure agreements protecting its right to use and control distribution of intellectual property in the event that the licensor files for bankruptcy protection. This modification of section 365 of the Code in essence allowed for prebankruptcy planning on the part of licensees.

The drafters observed that the modification of section 365 represented a substantial curtailment of the policy of protecting debtors in favor of the policy encouraging technological innovation.\textsuperscript{45} Importantly, in the legislative history of the Act, Congress advises the bankruptcy courts to recognize agreements that foster the development of intellectual property, even if these agreements technically contravene accepted principles of bankruptcy law.\textsuperscript{46}

Consistent with the public policy of encouraging technological innovation, the drafters enacted a broad definition of intellectual property.\textsuperscript{47} This definition covers a wide range of licensing arrangements and variants of intellectual property, including the following: (a) trade secrets; (b) inventions, processes, designs, or plants protected under title 35; (c) patent applications; (d) plant variety; (e) works of authorship protected under title 17 (Copyright Act); and (f) mask works protected under chapter 9 of title 17, “to the extent protected by applicable non-bankruptcy law.”\textsuperscript{48} Not all in-

\begin{footnotesize}
\begin{enumerate}
\item \textit{Id. at 4; see also supra note 35 (excerpt from Senate Report).}
\item S. REP., supra note 3, at 3. This reallocation of priorities was necessary because: Th[e] process [of technological development and innovation] begins with an inventive concept and must proceed through an expensive and risky series of steps including research, development, manufacturing and marketing. At each step, both money and additional refinement of the idea are required. Often, the financing and additional refinement are only available through the participation of persons other than the original innovator.\textit{Id.}
\item Id. at 9. As the drafters explained, the Act was “intended to restore confidence in the system of intellectual property licensing, and courts interpreting it should be sensitive to the reasonable practices that have and will evolve among parties seeking to add to the technological and creative wealth of America.” \textit{Id.}
\item \textit{Id. § 101(57) (1988) (“[m]ask work has the meaning given to it in section 902(2) of Title 17”).}
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intellectual property is covered under the Act. For example, trade names and trade marks are explicitly omitted from protection under the Act. Moreover, although the Act provides substantial incentives and protections to licensees, it does not provide any specific protections for (1) venture capital invested by licensors in high technology companies, (2) licenses entered into between debtor-licensees and solvent licensors, or (3) licenses of intellectual property that are assumed and assigned to third parties. For example, the drafters did not propose to protect a venture capital licensee’s investment by treating the licensee as a secured creditor, nor did Congress attempt to examine the effect that a licensee’s vested right to the technology would have on the rights of secured creditors. In addition, the drafters failed to address the situation in which the debtor-licensor owns the original intellectual property, and the licensee owns updates or supplements to the technology that are essential to the debtor’s use of the product. Finally, the Act is silent about the degree of adequate protection that must be provided to the licensee so as to permit assignment of the license to third parties. In these instances, the provisions of the Act may deviate from the judiciary committees’ stated purpose of protecting technological innovation.

III. The Protections Offered Licensees Under Section 365(n)(1)

Section 365(n), unlike most other Code provisions, was drafted with the expectation that licensees will engage in prebankruptcy planning. Indeed, section 365(n) explicitly allows licensees to modify contractual rights given to debtors and creditors under the Code.

These rights, addressed in the following subsections, include the debtor’s right to (1) reject onerous executory contracts, (2) enforce the protections of the automatic stay, (3) require notice and a hearing before property is removed from the estate, and (4) avoid adherence to ipso facto clauses. Although these rights are broad, the Act places the onus of drafting on licensees. If the right is not retained in the license, the non-Act provisions of the Code will undoubtedly be applied to the license agreement.

49 Arguably, the assumption and assignment of executory license agreements are governed under § 365(f) of the Code.
A. Section 365(n)(1)—The Licensee’s Right to Retain Its Vested Rights Under the License Agreement

Section 365(n)(1) provides that if the trustee or debtor rejects an executory license agreement covering intellectual property, the licensee may elect either one of the following courses of conduct:

(A) to treat [the] contract as terminated . . .; or (B) to retain its rights (including a right to enforce any exclusivity provision of such contract, but excluding any other right under applicable nonbankruptcy law to specific performance of such contract) under such contract and under any agreement supplementary to such contract . . . as such rights existed immediately before the case commenced, for—(i) the duration of such contract; and (ii) any period for which such contract may be extended by the licensee as of right under applicable nonbankruptcy law.61

According to the legislative history of section 365(n)(1), in the event that the license agreement is rejected, the licensor may retain the following rights under the terms of the agreement:

(a) Protection of trade secrets, copyrights, patents and confidential information against all persons including creditors;
(b) Continued exclusive use and distribution of the intellectual property for the length of the license as well as any extensions provided under the license or applicable law; and
(c) Enforcement of non-compete clauses against the debtor and any successor entity.62

The drafters recognized that the term of license agreements is often contingent upon the occurrence of certain triggering events, such as the approval of a patent application. Accordingly, the scope of section 365(n)(1) is not limited to contracts that have commenced as of the filing date. Rather, “[t]he benefits of the bill are intended to extend to such license agreements [that commence upon a ‘triggering event’], consistent with the limitation that the licensee’s rights are only in the underlying intellectual property as it existed at the time of the filing.”63

Section 365(n)(1) does not, however, protect the licensee’s right to property that is not fully developed, nor does it provide for reduction of royalty payments for use of such partially developed property. Therefore, although section 365(n)(1) provides a degree

63 S. Rep., supra note 3, at 8.
of prospective relief generally unavailable to parties to executory contracts, it ignores the economic reality that the licensor may file a bankruptcy petition before it completes development of the intellectual property. In that event, the contractual expectations of the licensee will be frustrated because the licensee will have the right to use the technology only in the form that existed as of the filing date, despite the fact that the parties contemplated that the licensee would benefit from the licensor's development of the technology into a more sophisticated form.64

B. Potential Drafting and Practical Problems Raised by Section 365(n)(1)

Although section 365(n)(1) provides substantial benefits to licensees who desire to retain their rights after rejection of the contract, it also has several defects that affect both licensees and licensors. For example, section 365(n)(1) provides no means of enforcing the terms of the license agreement. As a result, both parties must rely on the powers of the court to fashion an equitable remedy for breach of the license agreement.

Additionally, allowing the licensee to obtain possession and control of what may be the debtor's only asset violates the automatic stay provisions of the Code and the express prohibition against the ipso facto clauses. Nevertheless, under section 365(n)(1), if the license so provides, the licensee shall obtain use of the debtor's property without seeking relief from stay. Indeed, it would appear that the licensee may even use its common-law right of self-help to obtain the debtor's property.

In addition, whereas section 365(e) invalidates any provision of an executory contract (other than a license of intellectual property) that terminates or modifies the debtor's rights under a contract because of the debtor's insolvency or the initiation of bankruptcy proceedings,65 the provisions of section 365(n)(1) allow the debtor to enforce the ipso facto clauses contained in license and


65 Section 105(a) of the Code authorizes the bankruptcy court to use its equitable authority to "issue any order, process or judgment that is necessary or appropriate to carry out the provisions of this title." 11 U.S.C. § 105(a) (1988).

66 See id. § 365(e).
escrow agreements: The power to enforce ipso facto clauses creates the following anomaly: If the debtor assumes the license, the debtor will not be forced to reveal the components of its intellectual property to the licensee. If, however, the debtor rejects the license contract, the escrow agreement will be triggered, and the debtor will have to reveal its technology.

As one commentator points out, this anomaly creates a potential for abuse by the unscrupulous licensee. Indeed, once the debtor loses control of the technology, an unscrupulous licensee can utilize the technology in a manner unanticipated under the license agreement. A debtor that is preoccupied with its reorganization efforts will often be unable to prevent such abuse. Moreover, if the debtor is severely insolvent, it will be unable to muster a defense and provide the proof necessary to enforce its copyright, trade secret, or patent rights. In fact, if the copyright was not recorded or the patent not received, a substantial risk exists that the technology will enter the public domain.

C. Drafting Suggestions That Protect the Licensee's Vested Rights in Intellectual Property

To protect the licensee's rights under section 365(n)(1), the license should contain provisions that carefully define (1) the intellectual property protected from dissemination and (2) the scope of any exclusivity or distribution rights. The license agreement escrow provision or supplemental agreement should also fully articulate the rights that may be exercised by the licensee upon the bankruptcy of the licensor.

1. Defining Intellectual Property

The property must be described in detail to protect the licensee's vested interest in intellectual property. A careful definition of the property may provide licensees with greater protection under the Code than under federal, state, and common law rules because the Code contains a broader definition of intellectual property. For example, the Code makes "confidential information" a protected asset, whereas most state and federal laws do not protect licensees from the dissemination of information in which patent,

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Because section 365(n)(1) allows licensees to protect rights that will mature upon the happening of a triggering event, such as the granting of a patent application, the license agreement should define all intellectual property rights subject to pending patent applications or that may be developed during the term of the license agreement.

Furthermore, the license should define any embodiment of intellectual property subject to the license. For example, when the intellectual property is contained in equipment or a specialized casing, the license should provide that, in the event that the licensor files a petition for bankruptcy, the licensee may utilize an alternative method of obtaining the manufacture or assembly of the equipment.

2. Defining the Scope of Distribution Rights Afforded the Licensee

The license agreement should also define the licensee's distribution rights. If there are several licensees of the property, an issue may be raised regarding the validity of an exclusivity provision. Indeed, creditors may urge that since the debtor-licensor has already given more than one license, the estate would be best served if the intellectual property were mass-marketed. Accordingly, if multiple licenses are contemplated, it may be wise to define the contractual limits to be placed upon each licensee's distribution rights. The limits may be as simple as stating that only a specific number of licenses shall be given, or as complex as necessary to cover secondary distribution by original equipment manufacturers. In either event, the license should contain sufficient descriptive language to justify the business reasons for limiting the number of authorized licenses.

The license agreement should also define the scope of any noncompetition clause that binds the debtor and any successor entity. To ensure enforceability, the noncompetition clause should be limited to a reasonable time and geographic area and otherwise comply with applicable state and federal law.59

The license agreement should limit the ability of the licensor

or its creditors to sell the intellectual property to third parties who will not honor the license agreement.\textsuperscript{60} The right to retain collateral, to transfer title, and to obtain immunity from the suit described above is extremely limited.\textsuperscript{61} To preserve this right, commentators suggest that the agreement contain certain statements to strengthen the licensee’s position.\textsuperscript{62} Initially, the agreement should provide that possession of the intellectual property, as well as performance of the collateral obligations attendant to that possession, are necessary and that their sale to a third party would cause irreparable harm to the licensee. Furthermore, the agreement should state that receipt of the intellectual property by the licensee upon a default and a foreclosure is adequate and sufficient consideration. Finally, the debtor should waive the “commercially reasonable sale” requirement. Realistically, even under these circumstances, enforcement of such clauses cannot be guaranteed.

3. Defining Supplemental Agreements and Clauses

Section 365(n) does not permit the licensee to require the debtor to work or take any affirmative acts to enforce the rights of the licensee. Thus, if the licensee is relying on the debtor to perform any research and development work, the licensee or a hired third party must now perform this work. The licensee requiring such services should have the license agreement provide that third

\textsuperscript{60} See Duval, \textit{Defensive Drafting to Intellectual Property Agreements}, 2 \textit{BANKR. L.REV.} 18, 25-26 (1990). Examples of limitations suggested by commentators include the following:

(a) an agreement pursuant to section 9-505(2) of the Uniform Commercial Code which provides that, upon default the licensor must allow the licensee to retain the property, transfer title and provide the licensee with immunity from suit;

(b) an agreement that the intellectual property may not be sold to present competitors;

(c) an agreement that any sale of the intellectual property to third parties contain provisions which require the third party to perform the collateral obligations of the license agreement.

\textit{See id.}

\textsuperscript{61} See R. Nimmer, \textit{supra} note 33, §§ 5.11-.12 (limitations imposed may also cause parties to violate state and federal antitrust laws).


A person who is liable to a secured party under a guaranty, indorsement, repurchase agreement or the like and who receives a transfer of collateral from the secured party or is subrogated to his rights has thereafter the rights and duties of the secured party. Such a transfer of collateral is not a sale or disposition of the collateral under this Article.

\textit{Id.}; see also Duval, \textit{supra} note 60, at 25-26.
parties, in the event of a bankruptcy, may assume the debtor's obligations under the contract without violating any of the trade secret or exclusivity provisions of the license.

The license should further provide that payments under the contract may be reduced to account for any reduction in services occasioned by the rejection of the license agreement and allow the licensee to mitigate. It should be established that any reduced payments are not for royalties because there is no statutory basis to deny licensors their full royalty payments, even if the terms of the license contract are not being fully performed. Rather, section 365(n) and its legislative history expressly prohibit the licensee from reducing royalty payments because (1) the provisions of section 365(n)(1), which allow the licensee to enforce a rejected contract, are contingent upon continued payment of royalties by the licensee and (2) royalty obligations will be enforced regardless of the label given to the obligation in the license or supplementary agreement. In fact, the House Report on the Act advises the judiciary that

[i]t is important that courts, in construing the term "royalty" used in this subsection, and in deciding what payments are royalty payments, look to the substance of the transaction and not the label. The underlying nature of the payments must be considered. For example, payments based upon the use of intellectual property or on a percentage of sales of end products that incorporate or are derived from the intellectual property should be treated as royalty payments.

Based upon the foregoing legislative advice, it may be best to structure the license agreement as one for licensable rights (i.e., use of copyrighted information) and consulting services. This would, in effect, create two executory contracts. Thus, if a bankruptcy petition is filed and the debtor attempts to reject the contract, the licensee can halt payment for the consulting services under a breach of contract defense, while continuing to enforce the license agreement under section 365(n) by making its full royalty payments.

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63 Duval, supra note 60, at 23.
65 Id.
4. Escrow Agreements Under Section 365(n)(1)

Section 365(n)(1) allows the licensee to enforce any rights that the licensee may have negotiated under a supplementary agreement. This term includes escrow agreements. Under the typical escrow agreement, the licensor deposits a copy of the intellectual property, such as computer software or a patented formula, with an escrow agent. The escrow agent may be a mutually agreed upon organization, perhaps even a law firm. The escrow agreement generally requires that the escrow agent reveal or deliver the intellectual property to the licensee upon the occurrence of a triggering event. The triggering event often includes the filing of a petition for relief under the Code, appointment of a trustee or receiver, or a material change in the debtor's financial condition. Under section 365(n), the debtor need not provide continuing product support after the contract is rejected. Therefore, the escrow agreement should provide that the property deposited with the escrow agent must be updated on a monthly or weekly basis.

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67 S. Rep., supra note 3, at 9. The Senate Judiciary Committee observed that enforcement of supplementary agreements was necessary to effectuate the purposes of the Act because licenses are often only a part of the contract for development of intellectual property. As the Senate Committee observed,

[i]ntellectual property licensing arrangements are not generally standardized. Rather, the particular transaction is the product of the circumstances of the licensor, the licensee and other interested parties. It is not unusual for the licensing arrangements to involve parties other than the licensor and licensee. It is also not unusual for the license agreement to be one of several agreements governing the working relationship between the licensor and licensee. For instance, the licensor may have contracted to supply the licensee with a product incorporating the licensed intellectual property and may have agreed that the licensee would only have access to information necessary to produce the licensed intellectual property in the event of the licensor's inability or unwillingness to supply the licensee. To assure the licensee of access to such secret information at the defined time, the licensor may have agreed to turn over such information to a third party to be held in escrow until the triggering event. The third-party escrow agent would be a party to such an agreement, and the agreement would be set forth in a document separate from the basic license. Section 365(n)(1)(B), thus, speaks of the retention by the licensee of rights to the intellectual property under "any agreement supplementary to such contract." The licensee retains both the rights set forth in the rejected license itself and any agreement supplementary thereto, whether the supplementary agreement was itself the subject of a rejection by the trustee.

Id. (emphasis added).
68 See id.
69 It should be noted that this requirement, as a practical matter, may be difficult to obtain or enforce.
It has been suggested that the escrow agreement be supplemented with a security agreement granting the licensee a property right in the underlying intellectual property.\textsuperscript{70} Such an agreement would give the licensee the right to foreclose upon the collateral in the event that the licensor failed to perform its obligations under the license agreement.\textsuperscript{71} In addition, such supplemental agreements should contain an "after-acquired" property clause that would grant the licensee a security interest in all intellectual property developed by the licensor after the date of the agreement.

Although these agreements have a great deal of appeal from the licensee's point of view, the security interest they provide to the licensee may prevent the licensor from obtaining financing. Moreover, these agreements are workable only if the licensee has exclusive rights to the intellectual property.

IV. SECTION 365(n)(2)—THE DEBTOR-LICENSOR'S RIGHTS UNDER THE CODE

Section 365(n)(2) attempts, with limited success, to balance the benefits given to licensees under section 365(n)(1). This subsection virtually has eliminated the debtor's obligations to the licensee and has provided the estate with an unconditional income flow.

The debtor's obligations under section 365(n)(2) are passive. Section 365(n)(2) merely requires a licensor to "allow" the licensee to exercise its rights under a prepetition license and any supplemental agreement.\textsuperscript{72} In addition, section 365(n)(2) does not provide a licensee with any means of enforcing its rights under the license or supplementary agreement. Thus, if the licensor refuses to comply with the terms of the license agreement, the licensee must commence an action in the bankruptcy court to litigate its rights. The drafters of the legislative history describe this "compromise" as follows:

[Section 365(n)(2)] represents a careful compromise between the needs of the debtor and the licensee. The licensee requires retention of its rights, even exclusive rights. No longer can the debtor

\textsuperscript{70} See Duval, supra note 60, at 24.


\textsuperscript{72} Id. § 365(n)(2)(A). Thus, under § 365(n)(2), the licensee cannot, for example, require the debtor to continue to perform software development, provide updates or document codes granted the licensee under the escrow agreement. See id.
expect to sell these rights through rejection. The debtors’ ability to reorganize may depend upon preservation of the royalty payments called for under the contract, free of offset or administrative claims which could similarly defeat the right to royalty payments. The bill accomplishes this, but leaves unaffected the licensee’s rights under Section 365(g), so that a general claim for damages, if any, from rejection can be asserted by the licensee. 73

In exchange for being “allowed” to retain its rights under the license agreement, section 365(n)(2) requires that the licensee shall make all royalty payments designated in the license agreement for its entire term and for any extension thereof. 74 An extension of the license agreement may be imposed under the term of the agreement and applicable state or federal law. Unfortunately for licensors, section 365(n)(2) does not provide the court with the power to review the reasonableness of a license fee. If the royalty is below market rates, or subsequently falls below market rates, the licensee can require the debtor to continue the below-market rate license for the duration of the agreement plus any extensions. Fortunately for licensors, the converse is also true.

Section 365(n)(2) also limits the extent of the licensee’s claims against the estate. The statute provides that the licensee retains its right to assert a damage claim but is “deemed to waive—(i) any right of setoff it may have with respect to such contract ... or applicable non-bankruptcy law; and (ii) any claim allowable under section 503(b) of this title [for administrative expenses].” 75

Nevertheless, as the drafters explicitly informed the judiciary, “the bill does not [address] certain issues related to intellectual property that are already dealt with elsewhere in the Code.” 76 Thus, the licensor who rejects the contract and refuses to perform its affirmative obligations may be able to secure financial concessions, such as postpetition financing from the licensee, in exchange for the guarantee of future performance of its contract.

Conversely, section 365(n)(2) does not address the licensor’s right to require the licensee to perform obligations other than the payment of royalties. For example, the license agreement may require that the licensee market the software or conduct user groups and report suggestions to the licensor. Indeed, the license rate may

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73 S. Rep., supra note 3, at 10 (emphasis added).
75 Id. § 365(n)(2)(C).
76 S. Rep., supra note 3, at 5.
have been contingent upon the performance of these tasks. The licensee is getting the benefit of its bargain even though the license agreement has been rejected. Therefore, it seems fair that the licensee be required to continue both its monetary and nonmonetary obligations under the license agreement. Since the Code is silent on these points, the license agreement should contain provisions making these nonmonetary obligations a component of the royalty payments.

V. SECTIONS 365(n)(3) AND (4)—A STATUTORY MODIFICATION OF THE DUE PROCESS RIGHTS PROVIDED UNDER THE CODE

Sections 365(n)(3) and (4) provide that the parties to a license may contractually alter certain procedural rights given to debtors and creditors under the Code.

Section 365(n)(3) allows a licensee contractually to circumvent the necessity of notice and a hearing before intellectual property is "surrendered" to the licensee by a trustee or debtor. Instead, the parties can agree that if the debtor rejects the license, the licensee may require the debtor to surrender the intellectual property immediately.77 Section 365(n)(3) further provides that the debtor may not interfere with the licensee's right to obtain the intellectual property from another entity.78 Although section 365(n)(3) is not a model of clarity, it may allow the licensee to take possession of the intellectual property from either the debtor or its escrow agent and prevent the debtor from using the technology. Both of these acts could be accomplished without notice and a hearing. In fact, creditors who may have a security interest in the technology will have no means of perfecting this interest or attaching the collateral.

Section 365(n)(4) of the Code provides that the licensee may contractually alter the debtor's right to stay enforcement of an executory contract pending the debtor's decision to assume or reject.79 Instead, prior to the filing of a petition, the parties can agree that the licensor, upon written request of the licensee, shall perform the contract or provide the licensee with a copy of the intellectual property.80 Again, this contractual right seems to displace

78 Id. § 365(n)(3)(B).
79 See id. § 362(a) (providing debtor's right to stay).
80 Cf. H.R. REP., supra note 29, at 9 ("The trustee also is prohibited from interfering with the contractual rights of the licensee... including any contractual right of the licensee to obtain the property... ").
the need for a formal motion to assume or reject. More importantly, this Code provision eliminates the need for notice to the parties in interest, before transferring property of the estate.⁸¹

VI. PITFALLS FOR LICENSEES

Although the Act is designed to protect the licensee’s vested interest in the intellectual property, creditors who are aware of the license can prohibit transfer of the intellectual property to the licensee or invalidate the license agreement in toto by commencing certain legal actions available under the Code and elsewhere, including (1) injunctive relief,⁸² (2) avoidance of fraudulent transfers,⁸³ (3) avoidance of preferential transfers,⁸⁴ or (4) bankruptcy crimes, including fraud.⁸⁵

Additionally, the debtor or the creditors can assume the contract and assign it to an undesirable or uncooperative third party. Each of these pitfalls will be discussed below.

A. Injunctive Relief

Section 105 of the Code sets forth the broad equitable powers of the bankruptcy court and empowers the court to take all action necessary to “enforce or implement court orders, rules or to prevent an abuse of process.”⁸⁶ Under this section, the bankruptcy court is empowered to restrain a transfer of intellectual property if such transfer constitutes an abuse of process.⁸⁷

Likewise, section 107 of the Code provides that a bankruptcy court can issue restraining orders to “protect an entity with respect to a trade secret or confidential research, development, or commercial information.”⁸⁸ The House Committee on the Judiciary, involved in drafting section 365(n), anticipated that section 107 would be utilized to protect the trade secret or “confidentiality” rights of the parties to the license agreement. As the committee

⁸² Id. §§ 105, 107.
⁸³ See id. § 547 (this action may also be available under applicable state law).
⁸⁴ Id. §§ 547, 548.
The Committee is sensitive to the need to protect confidential material. But when adequate protection is needed, the Committee believes that Section 107(b)(1) of the Bankruptcy Code (11 U.S.C. 107(b)(1)) is sufficient to empower courts to afford adequate protection of confidential material.\(^9\)

Section 107 is a double-edged sword. On the one hand, it may be used by the licensee to enforce provisions of the Act by protecting the licensee's rights under the license or escrow agreement; on the other hand, it gives licensors and the parties in interest the right to move for injunctive relief to challenge the provisions of the license agreement that authorize unfettered disclosure of the technology to third parties pursuant to the ipso facto language in the license agreement. With respect to this issue, the congressional report provides:

HR 5348 does not change the requirement under Section 365(a) of the Bankruptcy Code (11 U.S.C. § 365(a)) that a trustee's decision to reject an executory intellectual property license agreement is subject to court approval. Though it is certainly not the only time the matter could be raised, a licensor-trustee concerned about protecting confidential information could ask the court to afford such protection under Section 107 at the same time the court weighs approval.\(^9\)

If injunctive relief is granted, the timing benefits of section 365(n) will be eliminated. Instead, continued research, development, marketing, and production will be terminated or severely impaired pending a final determination by the court.

**B. Voidable Transfers Under Sections 548 and 547 of the Code**

Although section 365(n) grants licensees of intellectual property the power to structure licenses that are not subject to the automatic stay provisions of the Code and that allow the licensee to obtain property of the estate without the approval of the debtor, trustee, and creditors, licensees should avoid transactions that appear to be fraudulent or overreaching. Indeed, the legislative history indicates that any reference to "non-interference by the trustee [in section 365(n)] is not intended to imply that the rights of the licensee enjoy any protection from the Trustee's avoiding

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\(^9\) H.R. Rep., supra note 29, at 7 (footnote omitted).

\(^9\) Id.
STRUCTURING LICENSE AGREEMENTS

power under sections 544 to 549 of the Code.\textsuperscript{91} Sections 544 through 549 of the Code contain the "strong arm" or "avoiding" powers of the Code.

For example, a license agreement may be challenged by the debtor, trustee, or creditors as a fraudulent or preferential transfer under sections 548 and 547 of the Code.\textsuperscript{92} Since section 101(40) of the Code defines "transfer" very broadly to include "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest,"\textsuperscript{93} a license agreement certainly constitutes a conditional transfer of an interest in property.

1. Licenses as Fraudulent Transfers

Section 548, the antifraud provisions of the Code covering fraudulent transfers, provides the following:

The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily—

(1) made such transfer incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or

(2)(A) received less than a reasonably equivalent value in exchange for such transfer or obligation; and

(B)(i) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;(ii) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or (iii) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.\textsuperscript{94}

\textsuperscript{91} 16 Bankr. L. Ed. 186 (1981).
\textsuperscript{93} Id. § 101(40) (emphasis added).
\textsuperscript{94} Id. § 548(a).
a. Section 548(a)(1)—The actual intent requirement

Section 548(a)(1) requires a showing of "actual intent" to hinder creditors and must be proved by "clear and convincing evidence."$^{95}$ Courts have observed that

"[a]ctual intent" in the context of fraudulent transfers of property is rarely susceptible to proof and must be gleaned from inferences drawn from a course of conduct. A general plan to strip the debtor of its assets without regard to the needs of its creditors "can support a finding of actual intent."$^{96}$

Courts have also inferred actual intent from the conduct of related parties. In these instances, some courts have applied a "foreseeability" standard. Thus, if the parties could have foreseen the effect of the transfer, they are deemed to have intended the result.$^{97}$

Some courts have found a presumption of fraud when a transfer occurs between two corporations controlled by the same parties. These courts determined that

[w]here principals of a debtor attempt to transfer corporate assets to a newly created corporate entity, which they also control, the transaction is fraudulent when the new corporation is merely a continuation of the debtor, controlled by the same persons, and made up essentially of the same assets and resources as the old corporation.$^{98}$

Fraud will also be presumed when the transfer occurs between two corporations controlled by the same officers and directors.

In addition, "certain 'badges of fraud' can form the basis for a finding of actual intent."$^{99}$ The "indicia" of fraud include the following:

1. a relationship between the debtor and the transferee;

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$^{97}$ See United States v. Glen Eagles Inv. Co., 565 F. Supp. 556, 581 (M.D. Pa. 1983), aff'd sub nom. United States v. Tabor Court Realty Corp., 803 F.2d 1288 (3d Cir. 1986), cert. denied sub nom. McClellan Realty Co. v. United States, 483 U.S. 1005 (1987). Applying state fraudulent transfer laws, the Glen Eagles court concluded, "[i]f the parties could have foreseen the effect on creditors resulting from [the LBO], . . . the parties must be deemed to have intended the same." Id.


$^{99}$ Wieboldt Stores, 94 Bankr. at 504 (quoting 4 COLLIER ON BANKRUPTCY ¶ 548.02 [5] (15th ed. 1987)).
2. lack of consideration for the conveyance;
3. insolvency or indebtedness of the debtor;
4. transfer of the debtor's entire estate;
5. reservation of benefits, control or dominion by the debtor;
6. secrecy or concealment of the transaction; and
7. pendency or threat of litigation at time of transfer.100

If a majority of these indicators are present, the license agreement may be subject to attack as fraudulent under section 548(a)(1). These standards could create problems for a licensee who has provided the licensor with a substantial investment of venture capital, or a licensee who is the marketing subsidiary of the licensor or its parent. Such a licensee could be considered an insider101 or an affiliate102 of the debtor-licensor. The court can examine the terms of the license agreement and determine whether the license was in reality a transfer made in exchange for a prior capital contribution or an attempt to defraud creditors. Alternatively, if the licensor requires the licensee to perform any capital-intensive services, and these responsibilities precipitate a bankruptcy filing, the court or third parties may question the licensee's "ulterior motive" for the transaction.103

b. Under section 548(a)(2), constructive fraud will suffice

Even if actual fraud cannot be found, the court may find constructive fraud under section 548(a)(2). Constructive fraud arises if the debtor received less than "reasonably equivalent value" for the license, and

(i) the licensor either was insolvent on the date of the transfer or became insolvent as a result of the transfer;
(ii) the remaining property of the company is unreasonably small for the company to continue its business operations; or
(iii) the licensor intended to incur, or believes that it would have incurred, debts beyond its ability to pay if these debts

102 Id. § 101(2).
were to become due.104

When intellectual property is licensed pursuant to a joint marketing or joint development arrangement, it is difficult, if not impossible, to determine whether “reasonably equivalent value” was given.105 This determination is especially difficult if the product has no ascertainable market value either because it has not been fully developed or is the first of its kind. If the parties are at arm’s length, it may be reasonable to assume that reasonably equivalent value was given. When the parties are subsidiaries of the same parent or when they are joint venturers, however, the court will scrutinize intensely all aspects of the transaction.106

Moreover, if the licensee is dealing with a start-up company, the company is often insolvent or rendered insolvent by its obligations under the license or development contract. Indeed, most start-up companies anticipate that they will operate at a loss during the development process and will not show a profit until several years after the initial beta test of the product. Accordingly, it is suggested that the license should contain a means of appraising the property in the event of a bankruptcy. Although this valuation mechanism would not be binding on the bankruptcy court, it could provide some guidance to the court in determining value.

2. Preferential Transfers

The trustee, debtor, or creditors may also seek to avoid a license agreement as a preferential transfer. Section 547 of the Code defines these transfers as

any transfer of an interest of the debtor in property—

(1) to or for the benefit of a creditor;
(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
(3) made while the debtor was insolvent;
(4) made—
(A) on or within 90 days before the date of the filing of the petition; or
(B) between 90 days and one year before the date of the petition.

105 It would be equally difficult to value intellectual property even if it were not a joint venture, especially if the property had a highly specialized use or limited market.
filing of the petition, if such creditor at the time of such
transfer was an insider;
(5) that enables such creditor to receive more than such
creditor would receive if—
(A) the case were a case under chapter 7 of the title;
(B) the transfer had not been made; and
(C) such creditor received payment of such debt to the
extent provided by the provisions of this title.\(^{107}\)

A transfer of intellectual property may be deemed preferential
if the royalties are, in reality, a repayment of preexisting debts held
by the licensee or its parent corporation. If, however, these royalty
payments fit within the provisions of section 547(c), they are not
preferences.\(^{108}\) It can be argued that royalties given in exchange for
exclusive use and distribution rights of software are transactions in
the ordinary course of business and constitute a contemporaneous
exchange for new value.

3. One-Sided Drafting of a License May Constitute a Bankruptcy
Crime

Section 152 of title 18 of the United States Code provides
criminal penalties for the commission of "bankruptcy crimes."

\(^{108}\) Id. § 547(c). The provisions of section 547(c) state that a trustee may not avoid a
transfer under the following circumstances:
(1) the transfer was intended to be a contemporaneous exchange for a new value;
(2) the transfer was in payment of the debt incurred by the debtor in the ordinary course of
business or financial affairs of the debtor and made according to ordinary business terms;
(3) the transfer created a security interest in property acquired by the debtor which secures
new value;
(4) the transfer was to or for the benefit of a creditor who gave new value to or for the
benefit of the debtor;
(5) the transfer creates a perfected security interest in inventory or receivable, or the pro-
cceeds of either;
(6) the transfer relates to the fixing of a statutory lien that is not avoidable under Section
545 of the Code; or
(7) if the case is filed by an individual debtor, the aggregate value of all property that con-
stitutes or is affected by the transfer is less than $600. Id.

other things, knowingly and fraudulently
[1] conceals from a custodian, trustee, marshal, or other officer of the court
charged with the control or custody of property, or from creditors in any case
under title 11, any property belonging to the estate of a debtor; or

[2] ... receives any material amount of property from a debtor after the filing of a
case under title 11, with intent to defeat the provisions of title 11; or
The penalty for the commission of a bankruptcy crime includes a fine of not more than $5,000 or imprisonment for not more than five years, or both. Accordingly, licensors should not use the licensing mechanism to "sell" or "transfer" technology in order to avoid paying creditors.

Clearly, if the license agreement is entered into as a means of transferring assets out of a company prior to the filing of a bankruptcy petition, the conspiring parties may be held liable for the commission of a bankruptcy crime.

VII. ASSUMPTION AND ASSIGNMENT TO THIRD PARTIES—THE LICENSOR’S ULTIMATE WEAPON

Although section 365(n) governs the assumption or rejection of a technology license, it makes no reference to, or prohibition against, the assignment of a technology license. Thus, commentators have observed that the licensor’s ability to assign a technology license is governed by section 365(f) of the Code. This assumption seems to be contrary to the letter and spirit of section 365(n).

A. The Dilemma

Notwithstanding any provision in the contract to the contrary, section 365(f) provides that the debtor or the trustee may assign to a third party an executory contract if such contract is assumed and if adequate assurance of future performance by the assignee is provided. Since adequate performance of the license agreement is not defined in the Code or case law, this section can result in a substantial threat to a licensee. Clearly, enforcement of an assignment could impair the provisions in a license agreement that require that the licensor uphold an exclusive licensing arrangement or that the licensor limit distribution of the product to certain vendors. Indeed, the contract may be assigned to a competitor of the licensor. Because adequate protection is not defined by the Code,

[3] . . . either individually or as an agent or officer of any person or corporation, in contemplation of a case under title 11 by or against him or any other person or corporation, or with intent to defeat the provisions of title 11, . . . transfers or conceals any of his property or the property of such other person or corporation.

See id.

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Id.

110 See Brown, Hansen & Salerno, supra note 54, at 198.

and because section 365(n) does not contain any provisions for the adequate protection of licensors of intellectual property, it will be difficult to argue that adequate protection includes assurance that the property will not be transferred to the licensor's competitors. Furthermore, there is a substantial risk that the assignor will not have the same level of skill required to maintain, service, or update the technology. In that instance, the licensee will be in an awkward situation because it will not be able to enforce the rights it would have obtained upon rejection of the contract—namely, the right to obtain the intellectual property from the escrow agent, and it will be forced to deal with an undesirable licensee or competitor.

B. Some Possible Solutions

Commentators have suggested that this potential problem should be addressed in the license agreement by defining adequate assurance of future performance. Although this provision would not be enforceable under either section 365(g) or (n), it could provide the court with suggested terms that an order authorizing the assignment of the technology license may contain. For example, the license could provide that any assignment would require that the assignee assume all of the debtor's obligations under the technology license. The license should also provide that certain net worth or capital requirements be met by the assignee to ensure that the service, maintenance, and research and development obligations originally bargained for can be completed. In addition, the contract may provide that the licensee shall have a right of first refusal to purchase the contract from the debtor instead of accepting the assignment.

An alternative method of prohibiting an assignment might be to provide that the contract involves personal services. This approach would require that the key persons involved in developing the technology be identified. If these persons can no longer perform the work, the licensee would have the option of terminating the contract.

Conclusion

Although section 365(n) of the Code clarifies some of the rights and responsibilities of licensees and licensors in the event of

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113 See Brown, Hansen & Salerno, supra note 54, at 198.
a bankruptcy, it is by no means clear that license agreements
drafted in compliance with section 365(n) will be enforceable as
intended. Indeed, since there is little case law on point, it is diffi-
cult to ascertain whether the agreements drafted by learned practi-
tioners will be enforced by the courts. In addition, section 365(n)
contains substantial “loopholes” that may allow debtors to escape
from its requirements. In this regard, overzealous licensees should
heed the adage, “Be careful of what you ask for because you may
get it.”

Under section 365(n), debtors can avoid many of the require-
ments of an onerous license agreement by simply assuming and as-
signing the agreement. Assignment of the agreement poses the
greatest danger under section 365(n) because the assignment may
be made to a competitor or to a party totally incapable of perform-
ing under the license agreement. Since the original licensor is
bankrupt and presumably unable to perform under the license
agreement, the licensee may be in a situation in which not only has
it lost the benefit of its bargain, but it is required to pay the royal-
ties to a party who is not providing adequate performance.

Therefore, after reviewing section 365(n), its legislative his-
tory, and correlative portions of the Code that impact upon it, it is
suggested that the party drafting the license agreement proceed
cautiously and advise the client of the substantial risks associated
with drafting any license agreement. In fact, when valuable tech-
nology is involved, perhaps the best advice is the oldest ad-
vice—possession is nine-tenths of the law.