Intellectual Property (IP) is becoming more and more important in today’s business world. There’s hardly an aspect of modern business that doesn’t involve IP, whether it be in a real property transaction, a bankruptcy, due diligence for a merger or acquisition or financing. In some cases, the most important part of a “deal” is the IP involved.

There are four key forms of intellectual property – patents, trademarks, copyrights and trade secrets, all of which afford certain rights and protections to the holder. Patents are property rights in designs or processes granted and formally recognized by the government to the inventor for a limited period of time. A patent can provide opportunities for revenue by licensing rights in and to a patent, but can also act as a shield against other inventors or would-be thieves of designs or processes. As such, patents can be valuable assets, especially for individuals or organizations whose business is derived from or formed around the patented subject matter (like a toy). Trademarks are the names, words, pictures, descriptions, logos, taglines, etc. that designate a product, idea, organization or other source for goods and services. Such marks can be formally registered or acquired at common law through first usage. Trademarks are central to branding for companies and for products/product lines alike. As leading branding tool a company’s reputation is often associated with or triggered by trademarks. Copyrights are the protected modes of expressing ideas, rather than the ideas themselves. Copyrights may be registered, but registration is not required to assert a copyright. Copyrights are also everywhere and apply to everyday aspects of our lives – the code of the software that enables programs to run on our laptops, the books we
read, the web pages we visit, the videos we watch on the internet – all are subject to copyright protections. Trade secrets are the confidential, proprietary information that maintain their value by remaining confidential, known only to its owner. While not formally or publicly registered, trade secrets are statutorily protected intellectual property. While trade secrets remain unknown, they often are at the core of an organization’s most valuable intellectual property. The rights and protections created in the intellectual property described above can both enable and hinder, but certainly always complicate business transaction.

Seemingly simple or straightforward transactions can be complicated by IP issues, often times issues raised by third parties. This CLE panel will explore the IP issues raised in four (4) common business settings. First, we will examine what type of IP issues arise when financing the purchase or license of software. Second, we will explore the best tips and procedures for conducting IP due diligence, whether it be in a merger or acquisition or other transaction. Third, we will delve into the complicated world of IP and bankruptcy. Finally, we will learn about the often overlooked, but sometimes critically important, IP rights associated with real property transactions.
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CHAPTER 4

Intellectual Property Issues with Software Financing

Leianne S. Crittenden*

1. Introduction

When a business wants to acquire equipment like office furniture or machinery, the common practice is to pay for the acquisition through some form of asset-based financing arrangement, such as an equipment lease. The lender (or lessor) will typically acquire a security interest in the equipment as a means of ensuring the repayment of its loan. However, what if the asset that a business wants to acquire is not a tangible asset, such as furniture, but is instead an intangible asset, such as computer software? What type of security can a business offer to obtain financing for such an acquisition, and what can the lender do to ensure repayment of the loan?

This chapter provides guidance for financing a business's acquisition of software products and services from a licensor, and information on the most common structures for financing that acquisition. It will

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1. Use of the terms "lender," "lessor," and "licensor" depend on the type of financing scheme used. For ease of reference throughout this chapter, the term "funder" will be used generally to refer to any person or business (be it a lender, lessor, or licensor) who agrees to finance the acquisition of software or other intangibles.
also identify the principal issues that both the business and the lender should consider when entering into a software financing transaction. Although it focuses on computer software financing, many of the issues addressed in this chapter relate to intangible assets generally.

Because computer software is protected in large part by copyrights, the information provided in this chapter focuses on copyright law. Conceivably, however, the financing strategies used by the software industry, and discussed in this chapter, may be extended to other high-tech arenas where patents are the predominant form of intellectual property (IP). If a different type of IP is involved in such transactions (such as patents, trademarks, or trade secrets), the governing law will differ and may raise similar but not identical concerns.

This chapter focuses on U.S. law. For transactions occurring outside of the United States, care must be taken to determine which laws (according to conflict-of-laws principles) are likely to apply and, if not U.S. law, what the requirements of secured financing are in the applicable jurisdictions.\(^3\)

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**Traps for the Unwary**

1. Do not lease an asset that you have not acquired or finance a license where payment terms exceed the duration of the license that is granted to the debtor.

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3. See UNCITRAL, *Legislative Guide on Secured Transactions*, available at [http://www.uncitral.org/en/leg texts/security/combinedlegisguide%20guide.pdf](http://www.uncitral.org/en/leg texts/security/combinedlegisguide%20guide.pdf) (guidance regarding the possible (and recommended) features of secured transactions laws in other countries. IP is defined therein as "copyrights, trademarks, patents, service marks, trade secrets and designs and any other asset considered to be intellectual property under the domestic law of the enacting State or under an international agreement to which the enacting State is a party").
II. Common Software Financing Structures

The most common structures for financing the acquisition of software licenses and related services are: (1) an installment payment agreement (IPA); (2) a lease; or (3) receivables financing for the software vendor (receivables financing).

An installment purchase contract or IPA is a short agreement that contains a licensee’s unconditional commitment to pay installments to acquire the assets subject to the IPA. The IPA will generally include representations and covenants as well as events of default and remedies separate from the terms and conditions in the license itself. An IPA is an extension of credit directly to the licensee and not to the licensor.

A software lease is similar to the terms of an IPA, but it also includes: (1) acquisition by the lessor from the licensor of the right to lease the use of the software to the lessee; and (2) end-of-lease term options (including a transfer of the right to use those leased assets from the lessor to the licensee, returning the leased assets, or renewing the lease). The licensor’s consent to any transfer of license rights may be required. A lease is also an extension of credit to the licensee and not to the licensor.

Where a software vendor assigns to a funder the sums due from the licensor’s customers, this is an extension of credit to the vendor (not to its licensees) and may be done on a nonrecourse or recourse basis, with the amount advanced to the vendor based on performance (payment) of the assigned receivables. In addition, given that the fees
may be proceeds of IP, IP laws (and not commercial financing laws) might apply to determine a funder’s rights under these transactions.

As noted above in “Traps for the Unwary,” the nature of the assets financed can lead to commonly used contract provisions becoming either ineffective or detrimental to a funder. Carefully review the contract you are using to determine whether the provisions will achieve your goals if the asset is not a tangible asset.

III. Identifying Intangible Assets That Could Be Financed

When a client asks you about financing the acquisition of software licenses, you might initially think it impossible. After all, most IP is not a tangible asset that you can feel or see. Rather, IP consists of statutory or contract rights that are more like air—but it can be very expensive air and can perform crucial functions for the end users of software.

There are a number of theories under which intangible rights such as IP might be the subject of commercial financing. From a commercial finance perspective, licenses are contract rights, and under existing case law,

4 people are usually surprised to hear that software licenses can be considered transactions in “goods.” Under Uniform Commercial Code (UCC) revised Article 9, licenses are classed as “general intangibles.” UCC Article 2A, which provides terms for “finance leases,” applies to leases of “goods” (UCC 2A-103(7)). Unfortunately, although licenses can have high value, it may be difficult to realize such value because existing laws may not provide specific guidance.

From the perspective of the owners and licensors of software, they have a statutorily granted right to control the distribution of their IP and to wring value from it. This right includes the right to sue for infringement if someone uses their software in a manner inconsistent

4. See, e.g., Commc’n Group, 138 Misc.2d at 86; RXX Indus., 772 F.2d at 543. See also Chapter 3 for information on how to perfect a security interest in IP.

5. Article 2 has been redrafted, and if adopted, it may change this because it does not, in its current draft, cover transactions in “information.” For a survey of the cases considering the applicability of U.C.C. Article 2 to software transactions, see Sys. Am., Inc. v. Rockwell Software, Inc., 218242 (N.D. Cal. Jan. 26, 2007) (not designated for publication) (reviewing existing cases involving transactions for development and licensing of software to determine whether they should be classed as provision of goods or services, and finding that an outsourcing arrangement for development of custom software is not a transaction in goods, but is a contract for the provision of services).
with applicable law, or the scope of the licenses they have granted (either by someone who is not authorized to use it, or by a licensee using it beyond the scope of the rights granted in a license agreement). Given that a licensor is unlikely to give up these rights, the critical question is how to structure a financing contract to provide certainty of repayment to the funder so that it is willing to invest its funds in financing the acquisition of this type of asset.

As with commercial financing generally, the key to making software financing work is to identify a transaction where full repayment will be made. This can occur where (1) the software can be used as security for the loan because it provides collateral value sufficient to provide a source of funds if it is remarketed by a funder in the event of a default, and a licensor will allow a funder to remarket the license if there is a default; or (2) where the licensor will not allow remarketing of the license by a funder, the software performs a critical function, and a funder’s right to terminate the licensee’s use of the software upon default is sufficient to motivate continued payment.6

Generally, three possible sources of income can serve as a basis for financing software transactions: the license, support services, and other services. Some of the issues to consider when financing these assets follow.

A. License

A license is the right to use a licensor’s property without being sued. So long as the license terms and conditions are not breached, the licensee has the right to use the licensor’s IP for the specified license term. Although an “exclusive” license may be the practical equivalent of ownership, because it is a license, it does not give the licensee all the rights that an owner would have. Where a license is “nonexclusive,” the licensee is one of a potentially infinite number of users of the IP that is licensed.

1. The Key Characteristics of a License

The scope of a license is determined by the terms of the license itself, so it is important to understand what rights have been granted and what

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6. For information on how to perfect security interests in intangible IP assets, see Chapter 3.
restrictions are in the license agreement. The key features of a license are as follows:

a. **Title.** A license conveys only a right to use and does not convey title in the underlying IP. An "exclusive" license to a specific party may not convey title because the licensor retains title to the licensed asset.7

b. **Duration.** It is important to determine whether the license rights granted are "perpetual" (e.g., the license grant lasts as long as the underlying IP rights last, so long as license terms are met), or whether the rights are a "term" license (the right to use ends after a specified period).

c. **Assignment.** It is also important to understand any restrictions on transfer. Some licenses may not have any restrictions on transfer, and others may not permit an assignment or transfer of any kind. This restriction can be important to a lender for several reasons. First, many lenders are secured creditors, and they will often make a "collateral-based" risk assessment to determine the likelihood of repayment. Typically, they would assess the transaction as follows: "If the debtor does not pay me, I can repossess the financed asset and sell or lease it to another party to mitigate the damages I incur as a result of the debtor's default." Where a license restricts or prohibits transfers by a licensee, however, this "remarketing" of the software will not be available to the lender, and if the lender suffers a loss because a debtor does not pay, there is no asset recovery to lessen that loss. The license can be financed, but the financing takes place without the lender's ability to mitigate damages through remarketing the "collateral." Similarly, a lessor must have a possessory interest to lease an asset because that is what a lease contract does (like a license, it provides an agreement that governs the right to use the lessor's property). If the license that will be "leased" cannot be transferred to the lessor, then the lessor has not acquired an asset that it can lease and is only providing financing terms, not the right to use that asset in return for lease payments.

d. Payment. Just because a funder pays for a license does not give it any rights in that license. A license is a contract that conveys certain rights to the licensee, so if you are not a party to the license contract, then you have no rights in it, even if you paid for it. UCC 9-408 makes it clear that although the grant, attachment, and perfection of a security interest in a licensee's license cannot be prohibited or limited by a license term, the enforcement of that security interest cannot take place without the licensor's consent. When you think about it, this makes sense: The licensor made a contract with its licensee (not with a bank or leasing company), has a payment obligation from that licensee, and has no reason to know or care about that licensee's lending arrangements. Be aware that under UCC revised Article 9, a purchase money security interest is not available for a transaction that is exclusively in software; that priority is limited to transactions in "goods."

2. Factors to Consider When Reviewing a License

a. Collateral Valuation. In many instances, a license right cannot be assigned by the licensee. As a result, a secured lender may not have any right to enforce its claimed interest against a licensor (UCC 9-408).

b. Derivative Rights. Given that a secured lender's rights are derivative (they are obtained through the rights that a licensee has and cannot be expanded), the most that a secured lender can get are the same rights the licensee has. As a result, if the license prohibits transfers or assignments, a secured lender may not have a right to take the license asset and transfer it to another party.

c. Security Interest Grant by Licensee. A grant of a security interest is a conditional assignment by a licensee (licensee assigns its license rights to funder as collateral, and if licensee defaults under the lending arrangement, then funder will have rights in the license). Before UCC revised Article 9 was enacted, it was unclear whether a grant of a security interest in a license could be made.8

8. For further information on how to perfect security interests in IP, see Chapter 3.
d. **Article 9 Provisions.** Revised Article 9 does allow blanket liens to cover all assets of a debtor, including a licensee's rights in licenses. Article 9 also overrides anti-assignment provisions in licenses so that a security interest can be granted, can attach, and can be perfected in the license rights, even if a license term prohibits assignment. However, UCC Article 9 explicitly limits such security interests by stating: "[T]he secured party (absent the licensor's agreement) is not entitled to enforce the license or to use, assign, or otherwise enjoy the benefits of the licensed software, and the licensor need not recognize (or pay any attention to) the secured party."

e. **In-Place Value.** Given the foregoing, the in-place value of a license becomes an important part of reviewing a transaction. What functions does the licensed software perform? Can those functions be easily replaced by the licensee? What would it cost the licensee to replace those functions? What is the value to a licensee? Is it high enough to motivate the licensee to continue paying for that asset?

f. **Cost of Goods Sold.** Unlike a goods-based transaction, there may not be a consistent "value" or "cost" for a license. Licenses can be very expensive or can be significantly discounted off the licensor's list price. Unlike tangible equipment, there is no "cost" of goods sold since the tangible media (a disk) can cost a nominal amount, or the software can be downloaded from a website (with no cost). Although the licensor will have a price list, and may have incurred significant development costs, the actual license fees can vary widely from licensee to licensee for many reasons. A licensor may wish to capture customers in a specific industry segment and may price its product favorably to obtain the annual support fees that will be obtained by licensees. A licensee may have an urgent need for a specific type of software to address a business issue and may be willing to pay significantly more than the price that would be paid by another entity (even where the number of users and rights granted are equivalent).

3. **Practice Tips Related to Licenses**

a. Lenders should carefully review the license terms to understand what rights the licensee has and what rights are reserved to the licensor.
b. Lenders should consider the functions that the software performs to assess whether those functions will provoke repayment (e.g., how important the software is to the operation of licensee's business).

c. Remember that there may not be an ability to assign or transfer the license without licensor consent. This means that a licensor can assert that it must consent to any assignment, whether it is a transfer pursuant to a bankruptcy proceeding or assignment for the benefit of creditors, or an assignment by a secured lender who has foreclosed on its security and now seeks to transfer the assets of the business to mitigate its damages. If that "remarketing" right is important, obtain licensor consent at the outset before the license is granted to licensee.

B. Support Services

For many types of software, a support contract is also offered by the licensor pursuant to which the licensor is typically paid a fee. This fee is often for an annual contract, payable in advance. In return for the fees, in accordance with the applicable contract terms, the licensee will receive telephone support to help with problems, bug fixes, and product updates (to the extent any are issued during the term of the support contract), as well as on-site or other services to assist with implementation. Support fees may be listed separately or may be bundled together with software fees.

Where software is complex, a support contract is almost always obtained from the licensor, and support services can be extensively used by the licensee. By using the support services and installing the released updates to the software, the licensee always has the most current version of the software and is more likely to fulfill its payment obligations, as it is not paying for outmoded technology. If the support contract gives the licensee a right to receive any updates to the licensed software, there may be a significant reinstatement fee if the support contract lapses. These factors make support fees a fairly reliable source of payments where a licensee is motivated to pay for them in full on a timely basis because they are crucial for the complex (and expensive) software that is essential to many business operations.
1. Key Characteristics of Support Services

Support provides ancillary services for licensed software. If there is no license, or if the license is not used, then support will not be utilized and fees will not be owed. The nature of support and the licensee's need for those services will determine the types of remedies a funder will want in its IPA or lease contract.

2. Factors to Consider with Support Contracts

Sometimes funders limit the amount of services that can be financed. Review the terms of the support contracts; if there is a significant reinstatement fee, and the licensed software is complex, the licensee may be motivated to continue to use and pay for the support services. Thus, limits may not be appropriate for that transaction.

3. Practice Tips Related to Support Contracts

Carefully consider whether to require maintenance of the support contract for as long as money is owed, like in equipment leases. This is not so that the asset can be remarketed at its highest value (either upon default or an unexercised lease purchase option) because the anti-assignment clauses in many licenses will limit or remove that remarketing, but so that the licensee will have the most current version of the financed software and be more likely to pay the remaining sums due for the financed license fees.

C. Other Services

Services related to software, such as consulting, can also be financed. Fees for implementation consulting are often incurred when a license is acquired.

1. The Key Characteristics of Service Contracts

In general, a service contract typically would not provide an asset to finance, because the services may be completely used up without obtaining any assets (either tangible or intangible). However, consulting services, when they are performed in conjunction with a license acquisition, may provide license rights, as set out in the following.
2. Factors to Consider When Reviewing Service Contracts

a. **Collateral Valuation.** “Consulting” can consist of services provided to determine what types of computer hardware to acquire to most effectively implement the licensed software, or consulting services can result in writing code that will allow the software to be implemented throughout a licensee’s business. Where code is written, the licensee will upon payment generally receive a license to use that code.

b. **What Rights Are Acquired?** Again, check the terms of the consulting agreement to understand what rights a customer will acquire. A consulting organization will want to reuse any code derived from a specific project and may eventually make a software product out of it; therefore, the consultants will seek to provide a license for the code that they write. A customer may negotiate terms that provide for its ownership of IP that its staff develops with the consultants. The license typically takes effect once the consulting organization receives payment.

c. **Timeframe for Provision of Consulting Services.** In addition, determine how long the consulting project will last. System integrators may want to finance their expenses of providing consulting services to their customer over a long-term project (with the related risk that over time the licensee will be unhappy with the progress of the project). On the other hand, the consulting project could also be a short-term, intensive burst of services used to quickly implement software acquired throughout an organization with services performed for 60 to 90 days. In that case, licensees may consider these costs as part of their acquisition and implementation of a valuable asset and will be glad to provide appropriate waivers of defenses if they can pay these expenses over time by financing them.

d. **Waiver of Payment Defenses.** Where consulting is financed, a funder will want to ensure there are adequate waivers of defenses to payment. Funders often want a confirmation that the services were received and that the fees are due to the consulting organization. A customer typically will not want to confirm that the consulting services “have been accepted” because they do not want to waive any right to make claims against the provider, but they may be willing to acknowledge that they will repay the funder without asserting defenses to payment.
3. Practice Tips Related to Service Contracts

A customer may not want to provide an “acceptance certificate,” such as those used in equipment financing transactions, stating that it received the services and that they are accepted because the customer may not want to waive any rights it could later claim against the consultant under the consulting agreement. In addition, the consultant often performs work on a time-and-materials basis where hourly fees are due for the work performed (instead of a “milestone” contract where payment is not due until specified milestones are satisfactorily completed), so “acceptance” is not required before payment is due from the customer.

D. Goods: Mixed Collateral

Where a software transaction also includes assets that would be characterized as “goods” under UCC Article 9, the funder must review what its rights would be and what requirements must be fulfilled to achieve those rights. For example, a transaction that includes only software is treated differently under the UCC than a transaction that includes computer hardware and software.

1. Purchase Money Security Interest

Under UCC revised Article 9, the super priority for parties that provide the money to acquire designated assets is only available for “goods.” A software-only transaction will not qualify because under Article 9, software is a “general intangible” (UCC 9-102(a)(44)). However, when the software is embedded in goods (the typical example is a car’s braking system), then those assets may be goods and the priority could apply. In addition, under 9-103(c), where goods and software are acquired in an “integrated transaction” and the software is acquired for the “principal purpose of using the software in the goods,” then a purchase money security interest can be acquired in the goods and software. This is intended to cover mixed-collateral transactions, such as computer systems, where there are goods and software acquired as part of a transaction, and the expectation is that the system is acquired as a single asset (so lien waivers should not be required for the software portion of that acquisition).
2. Chattel Paper

Most equipment funders expect their transactions will be classed as chattel paper. However, chattel paper applies only to leases of, or secured transactions in, "goods" (UCC 9-102(a)(11)). If you do not have goods, you will not have chattel paper.

3. Practice Tips Related to Mixed Collateral

Think about what your objective is before you decide what kinds of filings or registrations are needed. Think about how the underlying assets are categorized under Article 9 because that may affect the filings needed and where to file. Think also about whether a filing will have any effect once you have identified the type of asset that you are financing. Filing "early and often" may result in unnecessary expense and time-consuming work. It is understandable, where the laws are unclear, why a lawyer would advise his or her client conservatively (to file in a way to cover all possibilities), but some of the filings will have limited or no effect. (For information on how to perfect security interests in IP, see Chapter 3.)

E. Cloud Computing

The advent of so-called cloud computing, typically involving the storage of data and software on third-party servers, has raised additional issues related to software financing. A variety of options to access licensed software are available because the objective is to provide customers with lower cost and more efficient alternatives to a customer's internal IT staff. For this reason, if a funder provides financing for cloud services, it must understand the terms of the underlying agreements.

For example, among other terms, the transaction may: (1) be characterized as a monthly subscription service; (2) be cancellable upon short notice or occurrence of specified events; (3) decrease fees if performance standards are not met; (4) allow a customer to retrieve its data from the cloud environment under specified circumstances; or (5) provide flexibility to allow a customer to change products or amounts of services during the cloud services contract. The end-user may have a contract right to use software and servers on a cloud provider's facility, or may be entitled to have the software that is licensed to the end-user by another used (or hosted) in the cloud provider's data center (on the cloud provider's servers), with a right to take the license back into the end-user's facility upon certain conditions, or combine technology to
use on premise software already licensed to the customer along with cloud offerings, which will be migrated over time. Providing financing to a user of standalone cloud services will depend, among other factors, on how comfortable a funder is with the likelihood of cancellation, and whether fees will be due for a timeframe long enough to make sense for a transaction.

When considering whether to finance the operations of a cloud computing company, there are a number of things to consider. First, the cloud provider may have receivables from the payments made by many end-users, and these could be assigned or factored. Due diligence on the cloud provider's offerings, including frequency of downtime, renewals by customers, and other aspects of the business, must be done to determine whether a transaction with the cloud provider makes sense. For example, the cloud provider may prefer to acquire its servers through lease transactions so that the cloud provider can assess in a relatively short time whether it makes business sense to acquire the leased servers or get new ones as technology improves. Likewise, a review of what assets are being acquired by an end-user (versus what services are provided to it) should be done to decide whether there are any assets to finance. Typically, the data that is stored on a cloud provider's servers would be internal data owned by the end-user and used in running the end-user's business, so it would be difficult to get a security interest in it for a transaction with a cloud provider.

IV. Financial Products

Typically, a licensee's acquisition of software can be financed using two familiar financing contracts. The summaries to follow cover typical transactions, but other types of contracts, such as promissory notes and sublicense transactions used for financing purposes, can be used.

A. Installment Payment Agreement

An installment payment contract is often used to finance a customer's acquisition of software and services. The IPA will usually include unconditional payment obligations, events of default, remedies, and representations and covenants. The IPA typically is separate from the license that acquires the software. It may be entered by a funder or by the software vendor and then assigned to a funder. The party owed the
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payments under the IPA does not obtain an interest in the software license and other assets subject to that IPA contract, but generally has a right to exercise remedies which are limited under the UCC. The events of default are different than in an equipment-based IPA because the assets acquired are contract rights. Thus, instead of concepts of abandonment or repossession, one must consider the type of asset—a contract right—and ensure that analogous concepts are used.

1. Defaults

Instead of abandonment or other goods-based concepts involving loss of possessory rights in the asset, a software IPA typically has a provision that makes a termination of the license an event of default. This is because if a debtor/licensee is not using the asset, it may be less likely to continue paying. Lenders are not typically bargaining for an unsecured extension of credit without an effective remedy.

2. Remedies

Instead of repossession, the IPAs typically have a remedy of termination of the right to use the software, support, or services. The debtor will agree that if it defaults, then the funder can terminate its right to use the software. Given that the IPA is a separate contract from the vendor’s license, the funder should be able to directly enforce this remedy. In some instances, a funder will obtain a licensor’s consent that the licensor will observe or take action to terminate a defaulting licensee’s rights in a license. This agreement is obtained at the time the license is granted and the financing terms are extended. This can be in the form of a license amendment, or an agreement between the funder and licensor with the licensee acknowledging that the termination right is in place.

3. UCC Provisions

Absent a licensor’s agreement to provide assistance to a funder, UCC 9-408 comment 1 provides that a licensor “need not pay any attention” to a lender. Practically, this means that even if a lender had attempted to enforce remedies against the debtor/licensee to force it to stop using the software, a debtor/licensee could go to its licensor and ask for another copy of the software, or could use the software on another computer system, so long as the license permitted such use.
Practice Tips

In a software-only transaction, given that: (1) a funder that is a secured lender cannot take actions to realize value on the license (by assigning it to another party or using it in its own operations) if the funder does not have the licensor's consent; and (2) lien waivers or subordinations of prior security interests must be obtained (because purchase money priority is not available), the secured lender must assess whether it is worthwhile to seek and perfect a first-priority security interest in the licensee's license interest.

Given that the software financing is not often a "collateral play" because there may not be remarketing rights in the underlying asset, funders will often include a termination remedy in their contracts. The termination remedy is most effective where the financed software performs an essential function for the licensee and would be difficult to replace. If a funder decides to rely on its termination remedy under its financing contract, the UCC provisions can minimize the effectiveness of that remedy unless the funder has obtained licensor consent. In some instances, a software vendor provides an access key or code to the licensee if payments have been made, so if payments are not made, the access code is not sent to the licensee (effectively terminating a defaulting licensee's use of the software). However, this is not always the case, and as a result, some lenders ask for either agreements from licensors and licensees (in the form of license amendments) or confirmation from licensors that if the debtor/licensee defaults in its payments, and there is a termination of debtor/licensee's right to use, then the licensor will observe that termination. Again, if these additional transaction documents are required, they are usually requested at the time the license is granted because a licensor may not provide them after the transaction is closed.

4. Licensor Issues

Licensors will always want to preserve their rights under their license with the licensee. A licensor must be able to enforce the terms of its contract against the licensee, and in particular will want to continue to enforce remedies if there is a breach of the license. This right to exercise license remedies will exist alongside any rights that a funder has under its IPA.

Where a license transaction has already been completed, a licensor may not agree to any of the terms for which a funder asks because
this might cause the licensor to incur an additional obligation it was not required to do if the transaction were a cash transaction. Where lenders ask licensors to commit not to sell to a defaulting licensee, this can also cause issues for licensors (whose business it is to sell licenses) because even if the licensors agreed to a "no-sell" covenant, they may not be able to monitor sales of their product that are conducted through a distribution network or are made automatically through internet-enabled, web-based purchases.

5. Security Interest

Although UCC revised Article 9 clarified that the anti-assignment provisions in many software licenses are ineffective to prevent the grant, attachment, and perfection of a security interest in the licensee’s license rights, there are limits to what a funder gets. If the licensee’s interest in the license cannot be remarke ted or assigned because the license prohibits an assignment, then there are no proceeds of that license right. Even if a funder obtains a security interest from the licensee, under UCC 9-408 a licensor can ignore a funder, and the licensee has the right to use the software on another computer system if the license agreement so allows.

Practice Tips

To bolster a funder’s ability to assure that a licensee will not continue using the licensed software after a default, funders often ask licensors to observe the funder’s exercise of its termination remedy or to assist in implementing such termination. However, licensors' software accounting rules may limit the actions a licensor may take, particularly after a license has been granted, because any additional obligations on a licensor could be viewed as a concession that puts recognition of the related license revenue at risk. Confirmation on how such an agreement would impact a licensor under the relevant accounting rules is worthwhile because accounting rules are being revised.

B. Lease

Software can be the subject of a lease transaction if the transaction is structured properly. The most obvious requirement is that a lessor must acquire something to lease to the lessee. If the lessee already has entered into the license agreement, a lessor’s payment of the licensor’s invoices without obtaining an interest in the license may not be sufficient to give
the lessor a sufficient possessory interest to convey to lessee because lessee already has all of the license rights, and the lease adds nothing but a financing agreement. 9

1. Rights Obtained by Lessor and from Whom

a. Lessee Conveys an Interest in the License to Lessor. The lessor can get its interest from either the licensor or the licensee. If the licensee conveys an interest to the lessor, then this structure is analogous to a sale/leaseback. Where a lessee conveys rights in the license to its lessor, a software lease often requires the lessee to represent that it has obtained any necessary consents from its licensor. If it is important to ensure that the transaction qualifies as a lease, the lessor should review the license terms to confirm that the lessee is allowed to assign rights in the license to the lessor.

b. Licensor Conveys an Interest to Lessor or Consents to the Lease Transaction. A lessor may ask for licensor’s consent to a lease transaction, or may ask to be a sublicensor/licensor to the licensee, by acquiring an interest in the license from the licensor. A lessor must assess what rights it must obtain for the lease because, similar to an equipment lease, the lessor does not want to be responsible for product performance claims or warranty or refund obligations of the licensor or for copyright indemnities.

Sometimes a transaction is structured so that the lessor enters the license that the lessee has negotiated, and then the lessor will sublicense to the licensee on the same terms. In this structure, the license terms should be reviewed carefully because, as a sublicensor, the lessor may be assuming licensor obligations it does not want to take on (such as providing support and updates and providing indemnities for copyright infringement). If a licensor is no longer available to perform these obligations, a lessee might look to its lessor/licensor to perform them. Where a licensor consents to a lease transaction, the consent would generally spell out the rights of the parties as follows:

i. lessor obtains licensor’s consent to any transfer required from licensee to effectuate the lease transaction;

ii. licensor continues to have all rights to pursue remedies under its license upon a license default; and

iii. lessor may not transfer the license to anyone but the licensee (even if licensee defaults under the lease).
(Please note that other terms could be provided.)

Given that the license is already in effect, the lessor takes the license (and its terms and limitations) as the asset it will lease, including duration of the license and limitations on assignment to other parties.

Where a licensor transfers an interest in the license to the lessor so that lessor can enter a lease with licensee, the following generally reflects the rights and obligations of the parties:

i. licensor grants to lessor the right to convey through the lease the right to use the software;

ii. licensee/lessee’s right to use is limited by both the license and the lease;

iii. licensor continues to have all rights to pursue remedies under its license upon a license default; and

iv. rights that a lessee can acquire on exercise of any purchase option cannot exceed those rights originally granted by the licensor.
(Please note that other terms could be provided.)

2. Contract Terms

Many of the same contract issues set forth for IPAs, such as defaults and remedies, also apply to software leases. As in an IPA, a licensor will want to preserve its rights under the license against the lessee/licensee.

a. **UCC Article 2A Finance Lease.** Although the terms and conditions in software leases are quite similar to those found in equipment leases, UCC Article 2A may not apply (so the transaction would still be a lease but may not qualify as a statutory Article 2A Finance Lease). Unless the transaction is considered to be a “lease of goods” under UCC 2A-103(7), those provisions would not apply to provide a statutory finance lease with unconditional payment obligations. This must be addressed when drafting the lease provisions and structuring the transaction to assure that the lease contract covers all necessary points.

b. **General Terms in a Lease.** Some of the asset-related terms on an equipment lease will not apply to a software lease. A purchase option, for example, will not convey title to the software. Exercise
of the option can give the lessee only what it would have had under its license (without the lease) and cannot give the lessee more rights. If the original license granted only a term license (e.g., for five years), then a lessee's exercise of its purchase option under the lease cannot grant the lessee a perpetual license.

Terms such as return of the leased asset often will not apply. This is because in many instances, rather than return the software, an authorized representative will certify that it is destroyed or removed from the lessee's computer system. In addition, insurance or loss or damage provisions may not apply because the licensor may agree in the license to provide a replacement copy, or for complex software, the licensee may be authorized under the license to make backup copies for its computers in case its systems are damaged.

As previously noted, under the lease contract, a lessor will want to ensure that it is insulated from responsibility for providing services expected from the licensor (such as support for the leased software), from indemnities due to infringement claims, and from product-related disputes between the licensor and the licensee/lessee.

C. Factoring a Licensor’s Receivables

In addition to entering into transactions to extend credit to a licensor’s customers through IPAs or leases, a funder can provide a licensor with funds by factoring the licensor’s receivables. Here, commercial and IP laws can overlap, and case law provides limited guidance on how to structure these transactions.

Under UCC Article 9, the license fees due a licensor would be viewed as “accounts,” so a lender should be able to factor in those receivables. By filing its UCC financing statement, should it be able to ensure it has a first-priority right to those monies? That depends.

If the copyrighted materials are not registered under the Copyright Act, then that first-priority right would ensue. 10 If the copyrighted materials are registered in the Copyright Office, the license fees may be considered as “proceeds of copyrighted materials.” Without a registration in the Copyright Office, the lender’s interest may be unprotected because

10. See Aerocon Eng’g, 303 F.3d at 1120.
a UCC filing would have no effect for a transaction where the filing should have been made pursuant to the Copyright Act.\footnote{11. See Nat’l Peregrine, Inc. v. Capitol Fed. Sav. & Loan Ass’n \textit{(In re Peregrine Entm’t, Ltd.)}, 116 B.R. 194 (C.D. Cal. 1990); \textit{In re Avalon Software}, Inc. 209 B.R. 517 (Bankr. D. Ariz. 1997).}

In the \textit{Aerocon} case, a lender took a security interest under the UCC and the collateral included designs and plans that were not registered in the Copyright Office. In its decision, the Ninth Circuit upheld the bankruptcy judge’s finding that where there was no ability for a lender to file in the Copyright Office (because the materials were unregistered), then a UCC filing alone must be sufficient to provide public notice of a secured creditor’s interest in the debtor’s assets. The court specifically overruled (in part) the previous decisions in the area,\footnote{12. \textit{Id}.} indicating that a secured lender’s interest in any financing of copyrighted materials must be filed in the Copyright Office.

In the earlier \textit{Peregrine} case, a secured lender took a security interest in the monies the debtor received from showings of its film library, which were copyrighted materials registered in the Copyright Office.\footnote{13. Nat’l Peregrine, 116 B.R. at 194.} The decision clearly stated that if money from copyrighted materials was part of a lender’s collateral, then the filing evidencing the lender’s interest in those proceeds of copyrighted materials should be made in the Copyright Office. This led many lenders to insist that they would not provide lending arrangements unless the collateral were registered in the Copyright Office. As noted, in many circumstances a licensor will not want to register all pieces of software it licenses, or may not want to register them at all.

Registration in the Copyright Office may not secure the rights a lender wants because all software is not registered by licensors. A licensor may decide not to register its work in the Copyright Office because even the limited amount of source code revealed in the filing may be proprietary, and where a software product is updated (which is a common occurrence), the filing must also be updated. In some cases, licensors only register the most crucial aspects of their software because other filings would be cumbersome to maintain, and the product will be adequately protected through those filings. If a secured lender has rights in the crucial components, this may be adequate for their purposes.


...
judgment motion was partially denied in a case where a copyright mortgage was entered into with respect to a film that was not registered in the Copyright Office. In connection with a subsequent commercial loan, a lender had filed a UCC-1, but registration in the Copyright Office was made after the UCC-1 was filed. *Seven Arts* discusses the priorities of parties where a registration in the Copyright Office occurs after a lender files a UCC-1 against the unregistered work, stating that “if . . . recordation in the Copyright Office satisfied the requirements of Section 205 [17 U.S.C. §205], then [that] interest takes priority under federal law.” Thus, the priority established under state UCC laws would no longer be available because, upon registration, the federal regime preempts state laws on the topic (as the UCC acknowledges), and the federal filing system then applies.

*Practice Tips*

If there is no federal filing (because a filing of unregistered copyrights has nothing to attach to and will be rejected), then the UCC secured lender can lose its priority altogether if the copyrights are later registered. A lender typically will want a covenant that a debtor will not register in the Copyright Office, or make arrangements to preserve its priority if such registration does occur.

One possible way to structure a transaction is to document it as an assignment of the royalties due from the copyrighted materials. For sound recordings and motion pictures, this may result in a transaction subject to the UCC because the assignment of a royalty agreement would be subject to UCC Article 9.\(^\text{15}\)

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\(^{15}\) *Hayes v. Carlin Am., Inc.*, 99 Civ. 12515 (LLS) (U.S. Dist., LEXIS 16984 200); *BMG v. Hirsch*, 104 F.3d 1163 (9th Cir. 1997).
CHAPTER 7

Intellectual Property Due Diligence

Michael J. Dunne*

1. Introduction

Business transactions often involve, in one way or another, the transfer of intellectual property (IP) rights. Whether the transaction involves the sale or acquisition of a business, obtaining the exclusive license to a chemical process, the formation of a joint venture, joint marketing arrangements, or any of a myriad of other business transactions, IP rights will be implicated.

Although proper due diligence¹ is always important in business transactions, the need for proper due diligence when dealing with a technology-oriented² or other IP-driven business cannot be overstated. The concern for proper due diligence is especially high with relatively young high-tech businesses. The prices paid for those businesses are

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¹ The process of investigation carried on, usually by a disinterested third party (such as an accounting or law firm) on behalf of a party contemplating a business transaction (such as a corporate acquisition or merger, loan, or financing, or especially the purchase of securities) to provide information with which to evaluate the advantages and risks involved. MERRIAM-WEBSTER'S DICTIONARY OF LAW, available at http://www.reference.com/browse/Due Diligence (Merriam-Webster's, Inc. 2009).

² In this chapter, the term "technology" is used in a broad sense and is intended to include all forms of IP, including patents, copyrights, mask works, trade secrets, trademarks, and service marks.
often quite lucrative from the seller's perspective, but expensive and risky for the buyers. Consequently, a mistake in the acquisition of such a business can be quite damaging and, in some instances, has even caused the acquirer's demise. More than one buyer has purchased a business or a business's apparent IP (e.g., computer software, proprietary process, film library), only to learn subsequently that the IP rights were not what the acquirer expected or not as valuable as first thought.

The concern for IP due diligence cannot, however, be limited to just high-tech or other IP-driven companies. Today, almost any business relies to some extent on innovation and creativity and its ability to use and leverage its IP rights. The more important these rights are to an entity's core business, the greater the focus should be on IP due diligence, even when the acquisition or other transaction is not being made expressly for the purpose of acquiring such rights. In addition, although various techniques may be used to protect an acquirer after an acquisition deal closes (e.g., holdbacks in the purchase price, indemnification from the target or the target's principal shareholders, representation and warranty insurance), the best protection often turns out to be learning as much as possible before closing. The concept that prior investigation is the best protection is especially true where a major focus of the transaction is some type of IP or where IP plays a significant role in the business to be acquired.

II. The IP Due Diligence Process

Like all acquisitions, acquisitions of technology can take many forms. The two basic forms are: (1) a purchase of the entire business (e.g., purchasing the stock of the business, a merger, or an acquisition of all or substantially all of the entity's assets); or (2) a purchase or other acquisition of just certain assets. Where just the technology and the related assets are sought, the form of the transaction might be as simple and straightforward as a fairly standard asset purchase, or it may take on a more complex structuring of a joint venture or licensing or cross-licensing transaction. Regardless of the type or form of the transaction, conducting IP due diligence is essential.

3. For a definition of the "big four" IP rights, see Chapter 1.
Throughout this chapter, the concept of an acquisition is used to refer generally to the various types of transactions by which the ownership or rights to use or practice technology may be transferred.

**Traps for the Unwary**

1. A review of governmental filings may determine the target's IP rights; however, someone else may have an unacceptable and nonpublic interest in those rights. To be comprehensive, due diligence must also consider: (1) who developed the IP and how it was developed; (2) whether the target licensed or transferred any interest in the technology to a third party; (3) whether anyone else has an equal or superior interest in the same or similar IP rights; (4) whether there have been or are likely to be challenges to ownership or validity of the IP rights; and (5) the legal and practical barriers to a third party acquiring an interest in the same or similar IP rights.

2. To facilitate the due diligence process, the acquirer will generally enter into a confidentiality agreement with the target. Where the business people of the acquirer will be conducting due diligence, a risk exists that the acquirer will disclose confidential information to the target. In such cases, a mutual confidentiality agreement is advisable.

3. Be aware that under U.S. patent law, any "disclosure" of patentable inventions between the target and the acquirer could lead to a triggering of the one-year grace period in which to file a patent application. Failure to act within the one-year period could result in the loss of all patent rights in the disclosed inventions.

Whether the acquisition is a "stock deal," an "asset deal," a "licensing deal," or some hybrid transaction, and whether registered rights or trade secrets are being acquired, due diligence efforts in connection with the acquisition of IP or technology cannot end with the information received from the relevant recording office. Proper IP due diligence should, as a general matter, include at minimum the procedures described in the following.
First, the acquirer and its counsel must identify what IP rights are being acquired and the role the IP plays in the goals of the acquirer. The answer to those questions should control the scope of the IP investigation. In those instances in which the acquirer’s primary goal is to acquire and then exploit certain IP, such as a patented chemical process, a computer program, or a multimedia library of products, extensive and thorough IP due diligence may be required. However, extensive and thorough IP due diligence may be called for in other types of transactions as well. For example, in something as mundane as a bank acquisition, where additional market share or a new product are the stated goals of the acquiring bank, a proper due diligence investigation might disclose that much of what the acquirer seeks is based on a technological advantage of the target. Those technological advantages may be derived from technology the target sells, licenses, or otherwise provides to others or from technology it uses within its internal business operations. IP-related questions should then be asked, such as the following:

1. Does the target bank own the technology?
2. If the banks are merged, may the technology continue to be used?
3. If the technology is licensed, will the acquisition result in an increase in the license fees or other costs?
4. Will the technology work with the demands of the combined larger entity?

Before commencing the IP due diligence process, the acquirer’s lawyers and other advisors must understand and think through the goals of the acquirer for the acquisition and the role IP plays in realizing those goals, and then develop a suitable IP due diligence plan.

The actual process by which the due diligence investigation is conducted is as important as the specifics of the investigation. Placing insufficient attention on the process can result in both excessive costs and a flawed investigation. In addition to understanding the acquirer’s goals as discussed above, certain other general steps should be taken before the details of the IP due diligence review are determined or begun.

In addition to the goals of the acquirer, the scope of the due diligence review may be determined, to a great extent, by such general factors.

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4. For information on what type of IPR might exist and how to identify them, see Chapters 1 and 10.
as: (1) the target’s history with the acquirer or the target’s history with the IP at issue; (2) the type of target involved (e.g., small start-up, large public company, or foreign company); and (3) the industry involved (e.g., high-technology, computer, pharmaceutical, entertainment, or telecommunications). Those general factors may greatly influence the scope and the detail of the required review. For example, if the target is in a highly regulated industry, the governmental licenses it possesses may affect the use and application of its IP rights. In other words, it is important to step back and look at the overall picture before beginning the due diligence investigation.

Based on the general overview of the acquirer’s goals and the types of general factors discussed previously, the acquirer and its advisors should determine which IP rights of the target must be reviewed, the nature and scope of the review, and the initial requests for information to provide to the target. After the specific investigation begins, the acquirer and its advisors should frequently review the results of the investigation and determine whether the scope or aim should be adjusted. That process of continued review and reappraisal should continue until the technology review is complete.

Lastly, any review of the IP due diligence should not be done in isolation of the regular due diligence. Information gathered in one process may yield very important information for the other.

III. Cooperation and Confidentiality

Central to the entire due diligence process will be the full cooperation of the target. Without the target’s full and unfettered cooperation, the due diligence process is likely to be flawed and to arrive at erroneous conclusions. To help engender the necessary cooperation, the acquirer must likely enter into a confidentiality agreement with the target. The confidentiality agreement should be adequate to meet the target’s need for confidentiality without placing undue restrictions on the potential acquirer. If trade secrets are likely to be disclosed in the process, additional steps may be necessary to ensure there are sufficient “reasonable” protection efforts in place to meet the requirements of trade-secret law.

One question that often arises is whether the confidentiality agreement should be one-way, protecting just the target (that will clearly be disclosing information), or mutual (reciprocal), also protecting the
acquirer. In preparing and negotiating a confidentiality agreement, there are competing issues depending on whether the agreement is one-way or mutual. If you are representing the acquirer, and the confidentiality agreement is to be a one-way agreement protecting just the target, you may strive to limit the protections and/or enhance the exceptions. If the agreement is to be mutual because you are concerned that the protections go both ways, you are likely willing to expand the protections and narrow the exceptions for the benefit of your client.

Whether the confidentiality agreement should be one-way or mutual is another area in which counsel should step back and take a broad view of the due diligence process to determine which type of agreement should be used. Often with technology involved, a real risk exists that the acquirer will disclose some of its confidential information to the target in the process of gathering information from the target.

An acquirer will often use its employees most familiar with the technology to conduct the due diligence of the target's technology. If there will be discussions between those employees and their counterparts at the target, a mutual agreement is advisable. A potential downside to a mutual agreement, at least from the target's perspective, is that it may give rise to a trade-secret misappropriation or breach-of-contract claim against the target by the acquirer if the deal is not closed. If the confidentiality agreement was a one-way agreement protecting just the target and its information, the agreement would not form a basis for such claims.

However, counsel should not lose sight of the inevitable sharing of information between the counterparts of the two businesses. For example, it is easy to conceive of a conversation in which the technologist from the acquirer says something like, "Oh, that's the way you do that. What we do is ... How do you think that will work with what you are doing?" In such circumstances, it is likely that the target will be provided with the acquirer's confidential information. Consequently, counsel must look at the due diligence process, especially who will be involved, and determine whether a mutual agreement will best serve the client.

At the same time, counsel should caution their clients about who should be involved in the due diligence process. In assigning individuals to conduct due diligence, the acquirer again must consider the overall process and keep in mind that not all transactions close. Both the number of individuals and their association with the acquirer should be considered. As a general rule, the best approach in transactions involving technology is to limit the number of people involved to only
those who are truly needed to properly evaluate the information to be obtained and, when practical, not to use personnel who are involved in the acquirer’s own IPR development efforts.

Well-drafted confidentiality agreements will include an exception for information that is independently developed and information that was known prior to the disclosure. If a transaction fails to close and the potential acquirer subsequently competes directly with the former target, apparently using what the former target believes to be confidential information it disclosed in the due diligence processes, the former potential acquirer will find it easier to assert either of the previously discussed exceptions if: (1) the number of its individuals involved in the due diligence process was limited; and (2) those involved in its own development efforts had no exposure to the target’s confidential information.

IV. The Key Issues

Once the overview of goals and technology is completed and the confidentiality agreement is signed, the acquirer and its advisors should be in a good position to commence the appropriate IP due diligence. Depending on the importance of the IP to the acquirer’s goals, the IP due diligence investigation should focus to a lesser or greater degree on each of the areas discussed below. The following discussion presumes that IP plays an important role in the acquirer’s goals. Obviously, when IP is less important to the acquirer’s goals, the areas investigated might be fewer or the depth of the review lessened.

A. Identifying the Rights

In any acquisition with a focus on technology or creative works, the acquirer must first identify what IP rights the target owns, but identifying actual or potential IP rights alone is not enough. The acquirer should also determine to the best of its ability whether: (1) the target owns the IP rights being acquired; (2) any other person or business has any unacceptable (from the acquirer’s viewpoint) interest in such rights; (3) there are any unacceptable restrictions on the use or transfer of such rights; (4) there has been any challenge to those rights, either formally or

5. For information on how to find IP assets, see Chapter 10.
informally, or an informal evaluation of those issues by the target; and
(5) the legal and practical barriers to a third party acquiring an interest
in the same or similar IP rights are sufficient. The basic questions for
proper due diligence concerning a business’s IP rights are, therefore,
relatively simple and straightforward:

- How did the target acquire its ownership or other interest in
  the IP?
- If ownership of the IP rights is registered (e.g., patents, registered
  trademarks, and copyrights), does the chain of title trace back
  cleanly from the target back to the original registered owner?
- Has the target transferred any of its interest in the technology
  to any third party?
- Does anyone else have an equal or superior interest in the same
  or similar technology?
- Has anyone challenged the validity or ownership of the IP
  rights, or has there been an internal evaluation of those issues
  by the target?
- With respect to issued patents or registered trademarks, have
  all the interim maintenance or renewal fees been paid on
  a timely basis?
- With respect to unpatented inventions and trade secrets, have
  there been any disqualifying disclosures?
- What, if any, are the legal and practical barriers to a third party
  acquiring an interest in the same or similar IP rights and how
  significant are they?

Many of the concerns behind the foregoing questions are not all
that different from what a purchaser of real property considers before
purchasing. However, a stark difference exists between real property and
IP in how one determines the answers to those questions. With respect
to real property, a review of the appropriate government records and
the property will normally yield the necessary information, and once
acceptable answers are obtained, a potential purchaser may often protect
its prospective rights by filing an appropriate notice of settlement or
other notice in those same government records, placing all third parties
on notice of the purchaser’s potential interest.

Answers to the previously stated questions concerning various
types of IP rights require a more involved process because not all IP
rights are documented in government records. Depending on the type
of IP involved, the acquirer may need to review the filings in certain
government offices, such as the appropriate patent, copyright, and trademark offices. Rarely, however, will such a review provide all the information required to arrive at full answers to all of the questions posed previously. Particularly with respect to trade secrets, the acquirer will also need to review and understand the internal documents and processes of the target and explore the scope and significance of the target's business activities. In addition to reviewing available documentation, interviews of important personnel may be needed to determine the existence of hidden IP and to understand the nature of the target's relationship with various individuals and entities. (See Chapter 10 for information on how to find IP assets.)

B. Determining the Ownership of IP

The method for tracing ownership of IP depends to some extent on the type of IP involved. If the technology involves patented (or potentially patentable) technology, the due diligence investigation would include a review and evaluation of the patent records of the U.S. Patent and Trademark Office (USPTO) and perhaps other patent offices throughout the world. However, just because a patent has been issued to the target does not necessarily mean the target owns the patented technology, may use the patented technology without infringing the rights of others, or has all of the rights the acquirer may seek to acquire. Reviewing those records is merely a first step in determining whether the target has an ownership interest in the patent (or patent application) and the extent of any ownership rights.

Even if the records show that the target is the sole owner or assignee of the patent, that is not necessarily conclusive as to whether the target owns the patent rights. There may have been a later transfer of rights that has not yet been recorded but will still be effective against the acquirer if filed within the applicable period for filing after transfer. Additionally, one should review all transfer documents that purportedly give rights to the target.

The rule of U.S. patent law is that a patent is applied for in the name of the individual inventor(s) of an invention. This is consistent with the general rule of patent ownership that the person(s) who invents owns the invention. There are, however, a number of exceptions to the general rule.

One exception involves persons who were “hired to invent.” A sophisticated company, however, will not rely on this exception to
obtain ownership rights in trade secrets and patentable inventions, but instead will acquire invention assignment agreements from key employees and independent contractors. Thus, it is important during due diligence in tracing the assignment of IP rights to request and review such documents for what rights have been assigned and how they were assigned. For example, if the target has been assigned a patent that the acquirer may seek to enforce, the acquirer should determine whether the target was assigned the rights to sue for patent infringement, inclusive of the right to sue for infringement that occurred before the target acquired the patent rights. The absence of such a provision may affect the value of the patent rights to be acquired.

Be aware that because all inventors have full rights in the patent (unless transferred), one must ensure that all inventors have executed the appropriate invention assignment document. One should also attempt to ensure that a patent (or application) lists all the actual inventors and only the inventors. It may be that a patent application or an issued patent lists some persons who are not the actual inventors or omits inventors. Although it is relatively easy to correct this type of error, one should try to understand (and if so, preempt) any possible cloud over the patent's validity as a result of the right individuals not being identified as inventors.

Additionally, it had been the case that under U.S. patent law, the “first to invent” was entitled to a patent, not the “first to file” a patent application. Under the Leahy-Smith America Invents Act (the AIA), the United States shifted to a “first inventor to file” system for applications filed on or after March 16, 2013. This change has implications for what is considered “prior art” and will, over time, eliminate challenges based on “first to invent.” However, this change will not significantly alter how one conducts IP due diligence. It is still necessary to review the government patent records and relevant documents and interview individuals at the target to determine whether there are any issues that would affect the relevant IP rights or the value of such rights.

The simplest way to determine the ownership of trademarks and service marks is to examine the nature and scope of the target’s business practices and to identify all the trademarks and service marks it is

6. Under the Leahy-Smith America Invents Act (AIA), which was signed into law on September 16, 2011, for applications filed on or after September 16, 2012, an entity itself may apply for a patent if it has been assigned the rights by the inventor(s). That change in the law should not affect the efforts undertaken to verify ownership of a patent or patent application.

7. For example, the founder of a start-up business might insist that he or she be listed as the inventor when in reality the true inventor was an employee or independent contractor.
using. The general rule of U.S. trademark law is that trademark rights are created when one uses a mark as a source identifier or designator for goods or services. The major exception to this rule is when the mark is used pursuant to a license. Thus, in addition to identifying all marks a target is using, efforts should be undertaken to identify and review all applicable license agreements. (See Chapter 5 for a discussion of IP licenses.)

Once the list of trademarks and service marks is created, it can be compared to the records of the USPTO (and other trademark offices throughout the world) to determine which marks, if any, are registered. The records of United States and foreign trademark offices can also be searched to determine whether the target has any pending trademark applications. In this regard, it is possible for a company to apply to register a trademark and service mark before it is actually in use, and these intent-to-use marks can prove very valuable. In any such instance, part of the due diligence should ensure that the target has fulfilled the requirements for an intent-to-use application and that it can be perfected into a valid registration.

The search for copyrighted material is similar to the search for trademarks because such rights need not be registered with a governmental entity to exist, but often are. Therefore, the first step in identifying copyrighted works is to consider the nature of the target's business. Is it in the business of creating "works of authorship"? The acquirer should also determine whether the target is or has been in the business of acquiring the copyrights of others either through an assignment or a license.

Once it is determined the target creates or owns the copyrights in qualifying works of authorship, the investigation of ownership should focus on identifying the contributors to (or authors of) the work and their relationship to the target—a process that can be especially complex and difficult when a "multimedia" product is involved. As a general

8. Keep in mind that trademarks and service marks are broadly defined to include any symbol or device capable of distinguishing one's goods and services. Thus, in addition to word marks and logos, trademark rights might exist in the trade dress of product packaging, in the shape or color of a product, and in the sound and smell of a product.

9. Under U.S. copyright law, "works of authorship" include "literary works; musical works, including any accompanying words; dramatic works, including any accompanying music; pantomimes and choreographic works; pictorial, graphic, and sculptural works; motion pictures and other audiovisual works; sound recordings; and architectural works." 17 U.S.C. § 102(a). "Computer program" is defined as "a set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result" (id. § 101) and is considered a form of literary work. Computer software is also considered a form of literary work.
rule, the creators of a work of authorship own the copyrights therein. Furthermore, the ownership of the tangible embodiment of such work (such as a painting) is not the same as the ownership of the copyrights.

In the United States, the major exception to the general rule is what is known as the "work-for-hire doctrine." If a work was created by an employee in the course and scope of his or her employment, the copyrights in the work belong to the employer. In all other cases (and in most other countries of the world), a written agreement signed by the creators is needed to effectuate a transfer of ownership from the creator of the work to another. In the United States, such an agreement will either take the form of a copyright assignment or a work-for-hire agreement.10

For technology protected solely on the basis of trade-secret principles, the investigation may be more difficult and require an even closer analysis of the facts and the various governing legal principles. This is because trade secrets are never registered with a government entity and are often not even formally documented by their owners. (One may seek patent protection for trade secrets, but publication of the patent application will result in the loss of the secret).11 Instead, they may exist solely in the form of the day-to-day business processes of a manufacturing plant or in the mind of a senior executive. To determine the existence and ownership of trade secrets, it is necessary to interview key employees of the target and to identify any documents that may contain or refer to such secrets.

C. Identifying Transfers to Third Parties

Once the IP rights of the target are identified, some effort must be undertaken to determine whether those rights were licensed or transferred to a third party. Concerning IP rights that are an important part of the proposed acquisition, the target presumably will readily agree to represent and warrant that it currently owns such rights and that

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10. Not all works of authorship qualify for treatment as specially commissioned works for hire for which a work-for-hire agreement can be used. See id. § 101 (under which specially ordered or commissioned works for hire are limited to works that are "for use as a contribution to a collective work, as a part of a motion picture or audiovisual work, as a translation, as a supplementary work, as a compilation, as an instructional text, as a test, as answer material for a test, or as an atlas, if the parties expressly agree in a written instrument signed by them that the work shall be considered a work made for hire.").

they have not been licensed to another.\textsuperscript{12} However, proper due diligence requires the acquirer to conduct its own independent search for written license or assignment agreements. Consideration should also be given to how these rights have been used in the past and whether any person or company might claim an implied license to use the rights.

Although not necessarily complete, the records of the USPTO and the U.S. Copyright Office can be searched to determine if any assignment documents have been recorded with these authorities. Additionally, if foreign registered rights are involved, the applicable records of those authorities should also be searched. Records of financing statements should also be searched to determine whether anyone claims a security interest in the IP rights. (See Chapter 3 for a discussion of security interests in IP.)

D. Ascertain the Existence of Superior Interests

Just because a patent is issued or a copyright and trademark registration is obtained does not mean the listed owner of these rights is entitled to use the rights or that it can do so without infringing the rights of others. For patents, it is important to remember that a patent is merely the right to exclude others from practicing the described invention. It is certainly possible that a target patent owner cannot practice the patent because of other patents whose scope encompasses the invention in the target’s patent. These “blocking patents” are not unusual, and one should ask whether the target has information about potential blocking patents. There are also a number of legal theories by which third parties might assert superior interests in the patent.

As noted above, for patents issued on applications filed before March 16, 2013, someone else (unrelated to the named inventors) may claim that he or she was the first to invent and press such a claim either in the patent office (through what is called an interference proceeding) or as part of a court proceeding.\textsuperscript{13} For patent applications filed on or after March 16, 2013, a derivation issue and proceeding may arise whereby it is claimed that the patent owner is not the inventor at all, but derived

\textsuperscript{12} For a discussion of this type of representation and warranty, see Chapter 6.

\textsuperscript{13} With the “first-inventor-to-file” rule applying to post-March 16, 2013 applications, those challenges will ultimately diminish and be replaced, in some circumstances, with derivation proceedings. See 35 U.S.C. § 135. However, that process will take many years.
the invention from someone else (e.g., through the misappropriation of a trade secret).

Also regarding patent rights, sometimes one person is listed as an inventor when more than one person contributed to the invention; therefore, claims of "joint invention" may arise. Even if a patent was issued to the correct inventor, it is possible that the patented invention cannot be used either because it is against the law to do so or because it encompasses someone else's earlier invention.

For trademark rights, because the United States subscribes to a first-to-use system, it is possible that individuals or companies will have the priority of right to use a trademark within a particular geographic area or for a particular class of goods and services, even if the trademark is registered. Copyrights may be limited by the nature of the copyrighted works. For instance, if the work is highly factual or functional, the extent of copyright protection in the work is said to be "thin," and others may be free to use major portions of the copyrighted work without fear of infringement. Trade-secret principles protect secret information owned by a company or individual but, by definition, do not prevent others from independently developing or reverse-engineering the same secrets.

Due to the foregoing limitations on the scope of IP protection, it is always a good idea for the acquirer of a company to ascertain the "real" value of IP assets by looking beyond mere labels. Lawyers who are trained in the four IP disciplines can assist with such an analysis by, for instance, rendering an opinion concerning the validity of a patent or trademark. They can also be consulted to advise the acquirer about the actual scope of identified IP rights.

V. Practice Tips

1. If an initial review identifies an important piece of IP that includes registered rights or technology that may be registered by the target or a third party, a comprehensive review of any registrations and the corresponding files should be completed.
   a. Patents. Copies of all issued patents and pending patent applications (foreign and domestic) should be obtained. Patent counsel should be retained to analyze the scope of the claims and provide an opinion (either formal or informal) as to the validity of the patent claims, the potential for competitors to design around the claims, and the existence
of any blocking patents that might impact the usefulness or value of the target's patent portfolio.

b. Trademarks, copyrights, or mask works. The appropriate governmental office should be searched for evidence of ownership, third-party interests, encumbrances, and competing marks. For trademarks, a general trademark search should also be conducted and reviewed for potentially competing, pre-existing common-law marks that are not registered. Additionally, because trademarks and copyrights can exist without the issuance of a registration, to help determine what rights exist, the business activities of the target should be evaluated to determine whether common-law trademark rights exist and whether the target has created works of authorship that have not been registered.

c. Trade secrets. Trade secrets are often hard to identify because they are not always documented, so interviews of key employees should be conducted to identify such rights. Additionally, the acquirer should consider obtaining a patent search of related technology to ensure the alleged trade secrets do not infringe on any patented technology.

2. The acquirer should review: (i) all agreements with employees and consultants who were involved in developing or maintaining the technology or creative works; and (ii) all general policies, employee handbooks, and the like to determine what efforts the target takes generally to protect its IP rights.

a. Patents. The acquirer must determine who owns the patent rights. Employers do not necessarily gain the patent rights to their employee's inventions. The issue of ownership must be addressed by reviewing employment agreements, invention assignment agreements, and the like to determine whether the ownership of inventions is properly documented.

b. Copyright. The acquirer must determine whether any consultants were involved in the development of the work and, if so, that the consultants assigned all of their rights, including all copyrights, to the target, and when the assignments may expire by agreement or by operation of law. Pursuant to the work-for-hire doctrine, unless a copyrighted work was created by an employee in the course and scope of his or her employment, a proper written agreement is needed
to ensure the target, and not the creator of the work, owns the copyrights therein.

c. Trade secrets. The acquirer must ensure the target has taken adequate precautions to restrict or prohibit the disclosure to and use of the trade secrets by its employees and third parties. The acquirer should review confidentiality agreements (also known as nondisclosure agreements) used by the target with employees, consultants, customers, potential customers, joint venture partners, and so on.

3. The acquirer should review all agreements under which the target may have licensed or transferred any interest in the technology to a third party. The acquirer must confirm that any such license or transfer is limited enough to ensure, for example, that the licensee or transferee cannot become the acquirer's competitor and that the license is transferable and enforceable by the acquirer.

4. If the technology being acquired is based in any measure on the transfer of technology to the target, the acquirer must review the agreements and the law governing the transfer to ensure the target's rights are fully assignable.

VI. Evaluating the Collected Information

A. Registered Rights

When the initial overview identifies an important piece of IP that includes registered rights or technology that may be registered, a thorough review and evaluation of any registrations, or possibly related registrations (e.g., patent, trademark, copyright, and mask work registrations in the United States), and the corresponding government files should be conducted. For example, if patented technology is being acquired, patent counsel should, in addition to reviewing the patent prosecution history, analyze the scope of the claims and provide a formal or informal opinion as to the validity and scope of the patent claims and the potential ability of competitors to design around the claims.

With respect to software-related patents, if the acquisition is of a software product it may be wise to conduct a patent review and, if deemed appropriate, a patent search. Similarly, if the technology being acquired is protected as a trade secret, the acquirer may wish to obtain
a patent search of related patented technology to ensure the technology at issue does not infringe on any issued patent or run afoul of the claims of any published patent application. Similarly, if a trademark, copyright, or mask work is being acquired, the appropriate governmental office should be searched for proper evidence of ownership, third-party interests, other encumbrances, and competing marks.

Depending on the nature of the technology, the parties involved, and the market and potential markets for the acquirer, foreign registrations and opinions concerning the strengths and scope of the rights may also be required.

B. How the Technology Was Developed and by Whom

The acquirer should request and review all contracts and agreements with any employees or consultants involved in developing the technology or who are involved in using and maintaining the technology. Many nonlawyers and lawyers who do not practice regularly in the IP area do not understand (and often misunderstand) how initial ownership of IP is determined. The main point to remember is that merely paying for something to be developed (e.g., a software program) or paying an employee's salary does not necessarily purchase the ownership rights to the underlying IP rights. For example, if the technology at issue is copyrighted, the acquirer should determine whether any consultant was involved in the development of the work. If consultants were involved, the acquirer will want to ensure the consultants assigned all their copyrights to the seller.

A problem could arise over whether the consultant retained to produce the copyrightable work was a corporation or other entity. Take, as an example, a multimedia production. Although the company being acquired may be able to produce a development agreement with the appropriate work-for-hire and assignment language from the corporate consultant, a concern would nevertheless exist. The acquirer would remain at potential risk unless it ensured that all the consultant's independent contractors and employees who worked on the development of the multimedia production also entered into appropriate agreements assigning their IP rights.

If the technology at issue is patentable, the acquirer will want to determine where the patent rights reside. Even if such technology was invented by an employee of the target, issues of ownership must be
addressed because an employer does not necessarily gain the patent rights to its employees' inventions.

C. Rights in Software

If software is one of the assets being acquired, special issues regarding what is referred to as "open-source code" should be considered and addressed. (See Chapter 11 for more information.) Source code is the human readable instructions that are "compiled" into the "object" or "executable" code that is machine readable and that actually provides the instructions to the computer. Open-source code is source code developed and made available to all, but usually subject to certain conditions. Those conditions may range from the fairly harmless requirement to include an acknowledgment that the particular open source is included in the application, to the potentially fatal requirement that any software application developed using the open source, or that includes the open source, must be distributed free of any fees or charges and posted on the internet and made available to all. Given that the ramifications of open source can be devastating to the economics of an acquisition, if software is an important asset being acquired, counsel should advise the acquirer to consider whether a full source-code review should be conducted to determine what open source is included.

Software programs exist that do a fairly good job of searching a software application's source code for open-source code, but such programs will not catch all open source. Therefore, many acquirers will have programmers also conduct a manual review of the source code. If the acquirer determines to have a source code review conducted, regardless of whether the review is limited to an automatic review using one of the computer tools available or also includes a manual review, the acquirer should consider carefully who should conduct the actual review. Acquirers will be tempted to have the review done by their own programmers to minimize the costs. If the deal falls through, however, use of the acquirer's own personnel may lead to significant problems if the acquirer subsequently develops a competing software application. (See Section III, Cooperation and Confidentiality.)

D. Special Trade-Secret Concerns

If the technology is protected as a trade secret, the acquirer must investigate the efforts taken by the target to follow appropriate
confidentiality practices. The acquirer should review the confidentiality agreements used with the target's employees, consultants, customers, and potential customers. The acquirer should also review and test the actual practice of any written trade-secret policies and procedures of the target. The acquirer should review and observe the actual manner in which the target, its employees, and its consultants handle materials containing trade secrets. The acquirer should review the target's personnel files concerning the process used in the hiring and departure of personnel. The acquirer should determine whether the target uses exit interviews and whether the target's trade-secret policies and the former employee's obligations are reviewed and acknowledged by departing employees.¹⁴

In reviewing the agreements between the target and its employees and consultants that govern the use of a trade-secret or other confidential information, and entered into or updated after May 11, 2016, determine whether the target complied with the requirements of the Defend Trade Secrets Act of 2016 to provide notice of the whistleblower protections provided by that act. Although failure to provide such notice should not invalidate the agreements or the trade secrets, such failure may prevent the target and anyone succeeding to its interests from obtaining an award of exemplary damages or attorney's fees otherwise available under the relevant sections of that act.

If the trade-secret technology is patentable or copyrightable, the acquirer should determine whether all those involved in the development, including the individual employees and consultants, have assigned all their rights to the technology and have agreed to take all actions necessary to assist the target and its assigns in obtaining and defending any patent or copyright for the technology. If the technology is protected solely as a trade secret, a major concern will be whether the target has taken adequate precautions to restrict or prohibit the disclosure to, and use of, the technology by third parties.

E. Third-Party Interests

The acquirer should review all agreements under which the target may have licensed or otherwise transferred or disclosed any interest in the IP rights to a third party. If technology is licensed to customers of the target, all such licenses and related agreements with the target's customers should be reviewed to determine the nature and extent of the restrictions

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¹⁴. See Chapter 2 for more information about the features of trade-secret protections.
placed on each customer's use and disclosure of the technology. The acquirer must confirm, among other things, that any such license or other transfer is limited or narrow enough in scope to ensure that the licensee or transferee cannot become the acquirer's competitor and that the license agreement is transferable to, and enforceable by, the acquirer.

Although the latter point may not, at first blush, appear relevant in a stock purchase, certain licenses contain triggers, such as change-of-control provisions, where terms of the license change if a defined type of event (such as a change of controlling shareholders) occurs. Consequently, even in stock transactions, the license or other transfer agreements must be reviewed for the effects, if any, that such an acquisition might have on the rights and duties under such agreements.

In some transactions, the agreements are too numerous to all be efficiently reviewed within the scope of the transaction. In those instances, one can hope the target used form agreements. If so, it is often possible to review a percentage of the agreements that the parties agree represents a proper sample of the form agreements, and then rely on representations from the target or its principal shareholders concerning the use of the form and on the holdback or other post-closing remedies.

If the technology being acquired is in any measure based on the transfer of technology into the target, the acquirer must review the agreements governing such a transfer. For example, the acquirer will want to determine whether the target's rights under a license, development, or other technology transfer agreement are fully assignable.

In reviewing relevant contracts, the acquirer may find it can continue to utilize the third-party technology without any further action. On the other hand, it may learn it also must purchase rights to the technology or to a key portion of the technology from a third party, or that the third party must approve the transfer and has no obligation to grant such approval. It might also discover other adverse restrictions, such as additional restrictions on its use of the technology, or that all enhancements are automatically assigned to the developer/licensor.15

**F. Potential Hidden Liabilities**

In reviewing the various agreements with third parties, the target's obligations concerning IP representations, warranties, and indemnification should not be ignored. Depending on the nature of the acquisition,

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15. For information concerning the ownership of federally funded inventions, see Chapter 17.
such as a merger, the extent of the potential liability for IP indemnification might be important. In those instances, the acquirer should determine whether the target’s agreements place limits or restrictions on the scope of these indemnification obligations. Here the general due diligence and the IP due diligence should converge. The general litigation review should include a review of pending or threatened claims. The individuals involved in that review must be sensitive to the potential effects of claims or threatened claims involving the IP, including any challenges or interferences to the validity of claimed IP.
CHAPTER 9

Intellectual Property and Bankruptcy

Marc Barreca and John R. Knapp, Jr.*

I. Introduction

Intellectual property (IP) issues in bankruptcy can arise in at least two ways. First, if a debtor owns IP rights, those rights are a part of the bankruptcy estate and (subject to applicable IP rules) can be sold and distributed like other property of the estate. Accordingly, creditors of the bankruptcy estate and the estate’s trustee have an interest in ensuring that all the IP rights of a debtor are identified and secured. See Chapter 10 for information on how to find and identify such assets.†

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† See also Sharon K. Sandeen, Identifying and Keeping the Genie in the Bottle: The Practical and Legal Realities of Trade Secrets in Bankruptcy Proceedings, 44 Gonzaga L. Rev. 81, 92 (2008) (discussing the identification process).
IP issues also arise in bankruptcy when the debtor is either the licensor or the licensee of IP. As is discussed in Part II, bankruptcy can dramatically affect both licensors and licensees of IP. As a rule, bankruptcy does not affect previously terminated licenses. After a bankruptcy begins, however, the bankruptcy court supervises enforcement of rights under existing licenses, particularly regarding payment and termination. Problems arise in the context of the assumption, assignment, or rejection of IP licenses under 11 U.S.C. § 365 (the Bankruptcy Code). This chapter outlines the general principles applicable to IP licenses in bankruptcy and provides basic practice tips for licensors and licensees.²

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<td>1. Court approval will be necessary to terminate a license, notwithstanding contractual language providing for automatic termination upon a bankruptcy filing. On the other hand, a license terminated prepetition cannot be revived merely by filing for bankruptcy.</td>
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<td>2. The potentially harsh effects of anti-assignment restrictions and the prohibition on assumption of nonassignable licenses by the original licensee itself can be overcome by obtaining the prior consent of the licensor to assignment. In some cases, the prior consent required has been held to be a broad consent to all assignments, or even assumption. Debtors in possession and trustees may still be able to make use of existing license rights during the bankruptcy case even if, ultimately, the license must be rejected.</td>
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<td>3. Licensors should keep in mind the benefits of moving early for assumption or rejection of the license, especially if they are not receiving payment as obligations become due in the ordinary course of business post-petition, or it is otherwise uncertain whether post-petition use of the licensed rights will result in a priority administrative claim.</td>
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² For a more comprehensive reference on the intersection of bankruptcy and IP, readers may wish to consult WARREN E. AGIN, BANKRUPTCY AND INTELLECTUAL PROPERTY DESKBOOK (ABA 2016). Bankruptcy also affects security interests in IP because the trustee or debtor in possession may use the "strong-arm" powers provided in section 544 of the Bankruptcy Code to avoid unperfected security interests. The perfection of security interests in IP is discussed in Chapter 3.
4. Licensees should maximize the protection against rejection provided in 11 U.S.C. § 365(n)\(^3\) and realize its limitations and restrictions. Trademark licenses are not protected in section 365(n), and it is unclear how language in the Defend Trade Secrets Act of 2016 may affect trade-secret licenses.\(^4\) Future improvements and modifications to patented inventions or copyrighted work created after the date of petition are not protected. Additionally, section 365(n) provides no protection for license rights “springing into existence” after the date of petition.

5. Besides providing source code escrows or equivalent protections to fully take advantage of the rights provided under section 365(n), licensees may also want to consider taking a security interest in the underlying IP of the licensor to secure any actual or liquidated damages resulting from rejection or nonperformance of the license. In addition, to avoid litigation over the extent of royalty payments to be paid by the licensee for continued utilization of the license rights, the royalty paid for the IP should be specifically defined separately in the license from any consideration paid for other services or rights provided in the same contract.

6. Trustees (or Chapter 11 debtors in possession) should not forget to request the appointment of a consumer privacy ombudsman in a sale motion where personally identifiable information is proposed to be transferred inconsistently with a privacy policy. It is important to allow sufficient time for the ombudsman to be appointed and issue a report at the sale hearing. Personally identifiable information may not be IP per se, but may often be present and essential to the operation of an e-commerce business.

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\(^3\) See Xuan-Thao Nguyen, Selling It First, Stealing It Later: The Trouble with Trademarks in Corporate Transactions in Bankruptcy, 44 GONZAGA L. REV. 1 (2008).

\(^4\) As codified, the relevant provision of the Defend Trade Secrets Act of 2016 (DTSA), 18 U.S.C. § 1836(g), provides that, “[t]his section and the amendments made by this section shall not be construed to be a law pertaining to intellectual property for purposes of any other Act of Congress,” thereby raising the issue whether the Bankruptcy Code’s definition of IP to include trade secrets still applies.
II. How Does Bankruptcy Affect IP and IP Licenses?

A. General Principles

1. The Bankruptcy Estate Includes IP of the Debtor as of the Commencement of the Case

The commencement of a bankruptcy case creates an estate comprised of all the legal and equitable interests of the debtor. The scope of section 541 of the Bankruptcy Code is broadly construed and includes interests of the debtor "even if it is novel or contingent." Whether IP or any other property interest is included in the estate is generally determined under applicable nonbankruptcy law, including, for instance, the patent, copyright, trademark, and trade-secret laws of the United States. Thus, determining what assets are property of the estate is a common source of bankruptcy litigation.

2. Bankruptcy Does Not Revive License Agreements Terminated Prior to Bankruptcy

Bankruptcy has limited relevance to prebankruptcy termination of a license. A trustee or debtor in possession has no ability to revive a contract effectively terminated under state law prior to bankruptcy. Debtors in possession and trustees must generally conduct business in compliance with nonbankruptcy laws, including IP laws. The termination of a license prepetition precludes a licensee debtor (as a debtor in possession or its trustee) from using any of the IP post-petition. On the other hand, a prepetition termination by a licensor

8. See, e.g., In re Paige, 413 B.R. 882 (Bankr. D. Utah 2001) (determining that domain name "freckreditscore.com" was property of the estate due to debtor's dominion or control); In re CTLI, LLC, 528 B.R. 359 (Bankr. S.D. Tex. 2015) (determining that Facebook page was property of the estate, subject to terms of use, despite claims of disgruntled former owner holding administrative privileges for the page).
10. See, e.g., In re Valley Media, Inc., 279 B.R. 105, 143 (Bankr. D. Del. 2002) (holding that vendors of copyrighted compact discs, DVDs, and VHS tapes could block post-petition distribution of the copyrighted material where license was terminated prepetition).
debtor also terminates all rights of the nondebtor licensee, and the nondebtor licensee is not entitled to any of the protections of section 365(n) of the Bankruptcy Code, discussed infra.\textsuperscript{11}

There are at least two caveats: (1) state or other applicable nonbankruptcy law must be consulted to determine whether termination was actually effective;\textsuperscript{12} and (2) the termination of a right that has value to the bankruptcy estate may constitute a preferential transfer or fraudulent conveyance that may be subject to avoidance by the bankruptcy court in an action by the debtor in possession or trustee.\textsuperscript{13} In addition, the grant of a license may be revoked by a debtor in possession or trustee using the "strong-arm" powers of section 544 of the Bankruptcy Code, the preferential transfer provisions of section 547, and the fraudulent transfer provisions of section 548. Among other rights, the debtor in possession has whatever rights a hypothetical judicial lien creditor or an unsecured creditor would have to avoid transfers of property and recover them for the benefit of the estate.\textsuperscript{14}

3. Bankruptcy Sets Deadlines for a Trustee or Debtor in Possession to Decide How to Proceed Concerning Its IP Licenses, to the Extent They Constitute Executory Contracts or Unexpired Leases

In Chapter 7 liquidation cases, under section 365(d)(1) of the Bankruptcy Code, a trustee must assume or reject an executory contract

\textsuperscript{11} In re AGI Software, 199 B.R. at 860 (granting declaratory judgment against nondebtor licensee that no rights existed under section 365(n) where debtor licensor terminated license prepetition).

\textsuperscript{12} See, e.g., In re Waterkist Corp., 775 F.2d 1089 (9th Cir. 1985) (possession of leasehold premises coupled with state antifeasurale laws may allow debtor to assume purportedly terminated lease); In re Dixon, No. A07-00209-DMD, 2007 WL 1589555, at *1 (Bankr. D. Ala. May 31, 2007) (granting relief from stay to landlord where real property lease terminated under Alaska law on state court's issuance of prepetition judgment and writ of assistance requiring debtor to vacate premises in unlawful detainer action contested by debtor).


\textsuperscript{14} 11 U.S.C. § 544(a)(1), (b)(1); In re World Auxiliary Power Co., 303 F.3d 1120 (9th Cir. 2002) (holding that strong-arm power could not avoid security interest in unregistered copyrights as U.C.C. filing was sufficient to perfect); In re Peregrine Envt'l., Ltd., 116 B.R. 194 (C.D. Cal. 1990) (holding that secured creditor's interest in registered copyrights could be avoided using strong-arm powers where no filing was made with the U.S. Copyright Office); In re Franchise Pictures, LLC, 389 B.R. 131, 142 (Bankr. C.D. Cal. 2008) (granting summary judgment to debtor in possession dismissing creditor's claim where judicial lien was unperfected as to registered copyrights because creditor failed to record it with U.S. Copyright Office). See also Chapter 3.
or unexpired lease of personal property within 60 days of the order for relief, or the subject contract lease is deemed rejected. The court may extend this time for cause.

In Chapter 11 cases, under section 365(d)(2) of the Bankruptcy Code, a trustee or debtor in possession may assume or reject an executory contract or unexpired lease of personal property at any time before confirmation of a plan. However, the nondebtor party to the contract or lease may move the court to set an earlier time for assumption or rejection or for relief from stay to terminate the agreement; otherwise, the nondebtor party is required to continue to accept performance from the debtor.\(^\text{15}\)

4. **The Automatic Stay Prevents Termination of a License during Bankruptcy without Bankruptcy Court Approval**

The automatic stay of section 362(a) of the Bankruptcy Code precludes unilateral termination of a contract by a nondebtor party before its expiration. Courts have held this to be so even where the contract provides for at-will termination.\(^\text{16}\) Even if the debtor commits a postpetition breach, the nondebtor party must obtain relief from stay to terminate the contract.\(^\text{17}\)

5. **The Nondebtor Party’s Limited Enforcement Options and Payment Rights Require Bankruptcy Court Approval**

The debtor in possession or trustee, unlike the nondebtor party, may enforce a license in accordance with its terms in the “limbo period”

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15. *In re Valley Media*, 279 B.R. at 138 (citing *In re West Elec.*, Inc., 852 F.2d 80, 82 (3rd Cir. 1988)).


17. *In re Valley Media*, 279 B.R. at 137.
after the bankruptcy case filing but prior to assumption. A nondebtor party to a license may not enforce the license prior to its assumption and instead must move the bankruptcy court to set a time for assumption or rejection. The nondebtor party may also seek post-petition payments as an administrative expense-priority claim to the extent of the value of the benefit provided to the debtor in possession or trustee during the bankruptcy. This value may be difficult to prove.

Even if the debtor in possession or trustee uses goods provided under an executory contract, if the goods were delivered prepetition, no "postpetition benefit" is conferred. It may be possible to assert administrative expense priority for the value of IP received by


19. See generally, N.L.R.B. v. Bildisco & Bildisco, 465 U.S. 513, 531–32 (1984); In re Gunter Hotel Assocs., 96 B.R. 696 (Bankr. W.D. Tex. 1988). The deadline can be shortened, but it can also be extended. The bankruptcy court may find it appropriate, pursuant to a mechanism in a plan, to extend the time to assume or reject the contract after confirmation, such as necessary to clear up uncertainties about whether the contract is executory. See DJS Properties, L.F. v. Simplot, 397 B.R. 493 (D. Id. 2008) (affirming confirmation of plan with such a mechanism).

20. See, e.g., In re Dant & Russell, Inc., 853 F.2d 700, 707 (9th Cir. 1988); In re Coast Trading Co., 744 F.2d 686 (9th Cir. 1984); Union Leasing Co. v. Peninsula Gunite, Inc., 24 B.R. 593 (9th Cir. B.A.P. 1982); see also In re Nat'l Refractories & Minerals Corp., 297 B.R. 614, 618 (Bankr. N.D. Cal. 2003) (noting that requirement of benefit to estate in In re Dant & Russell has been superseded by statute in section 365(g)(3) as to unexpired leases of nonresidential real property). There may be a factual question about whether the debtor's obligation became fixed before or after the filing of the petition. See In re Designer Doors, Inc., 389 B.R. 832, 836–37 (Bankr. D. Ariz. 2008) (finding that bringing hazardous materials onto premises first prepetition did not give rise to post-petition claim); In re IFH S&B Holdings LLC, 401 B.R. 96, 102–03 (Bankr. S.D.N.Y. 2009) (obligation to remove liens arose post-petition, when liens were filed according to state law); see also In re Lucre, 434 B.R. 807, 833–34 (Bankr. W.D. Mich. 2010) (holding that rate of post-petition claim would depend on whether relationship arose from executory contract or telecommunications licensing arrangement). If the relationship is based on a commercial equipment lease, one court has held that the appropriate rate of administrative expense is definitively actual rent under the lease for the period in question. See In re Sturgis Iron & Metal Co., 420 B.R. 716, 762 (Bankr. W.D. Mich. 2009).

21. See, e.g., In re Kmart Corp., 293 B.R. 905 (Bankr. N.D. Ill. 2003) (software provider's post-petition software modifications for use in store that never opened were of no value to estate).

22. See In re DAK Indus., 66 F.3d 1091 (9th Cir. 1995) ("a software user is a licensee rather than an owner of a copy where the copyright owner (1) specifies that the user is granted a license; (2) significantly restricts the user's ability to transfer the software; and (3) imposes notable use restrictions.") (Vernon v. Autodesk, Inc., 621 F.3d 1102, 1111, 1114 (9th Cir. 2010) (distinguishing "economic reality" of relationship from DAK Indus. In that copyright owner in Autodesk did not sell copies of software but only licensed them to customers, which precluded application of the first-sale doctrine or the essential-step defense); see also Adobe Sys. Inc. v. Christenson, 809 F.3d 1071, 1080 (9th Cir. 2015) (in the absence of a license agreement that "significantly restrict[ed] the user's ability to transfer the software," a downstream customer is deemed to be an owner, not a licensee) (citation removed).
the debtor within the 20 days prior to the commencement of the bankruptcy case in which the IP has been sold to the debtor in the ordinary course of its business, to the extent the IP is "goods" and is "sold." There is no definition of goods in the Bankruptcy Code. Bankruptcy courts normally use the definition from section 2-105 of the Uniform Commercial Code: "all things . . . which are movable at the time of identification to a contract for sale." Whether a thing is a good may be determined after "taking into consideration the nature and common understanding of the thing, but also its similarities to goods that fall undisputedly under the UCC . . ." 

Although as of yet no courts have spoken to whether computer programs are entitled to priority under section 503(b)(9), courts have applied article 2 of the Uniform Commercial Code (UCC) to determine that computer programs, once loaded on a disc or other tangible medium, are goods that can be sold. "That a computer program may be copyrightable as intellectual property does not alter the fact that once in the form of a floppy disc or other medium, the program is tangible, moveable and available in the marketplace." Other courts have determined that although software may be goods, article 2 does not apply where the applicable contract is not a sale, but is a license agreement.

The premise of the decisions determining software to be goods may be coming under strain as software is increasingly delivered as a download, as a service, or in the cloud. To the extent article 9 of the UCC can provide any additional guidance, there might be a distinction between computer programs embedded in hardware (i.e., inherently

25. Id. at 798.
26. Id. at 799–800 (affirming bankruptcy court’s finding that electricity is a good); but see In re NE Opco, Inc., 501 B.R. 233, 256 (Bankr. D. Del. 2013) (holding that electricity is not a good).
27. Whether a claim is for the value of goods or nongoods is the basic for an objection. See, e.g., In re Circuit City Stores, Inc., Case No. 08-35653 (KRH), Docket No. 3309, Debtors' Fifth Omnibus Objection to Certain Misclassified Non-Goods 503(b)(9) Claims (Bankr. E.D. Va. 2009) (categorizing various nongoods claims and citing authorities in support of objections to 503(b)(9) status). Various courts in dicta have used IP as an example of nongoods. See, e.g., In re Pilgrim's Pride Corp., 421 B.R. 231, 239 (Bankr. N.D. Tex. 2009).
part of the goods) and computer programs separately contained on a disc or other tangible medium, and possibly a different result than under article 2.

The article 9 definition of "goods" includes computer programs that are "embedded in goods and any supporting information provided in connection with a transaction relating to the program if (i) the program is associated with the goods in such a manner that it customarily is considered part of the goods, or (ii) by becoming the owner of the goods, a person acquires a right to use the program in connection with the goods. The term does not include a computer program embedded in goods that consist solely of the medium in which the program is embedded."31 However, "software" is also "a computer program and any supporting information provided in connection with a transaction relating to the program," but not a computer program that is included in the definition of goods.32 The topic is simply unresolved and open to interpretation, particularly in light of the so-called internet of things that relies heavily on embedded software.

6. Insolvency or Filing for Bankruptcy Alone Is Probably Not a Basis to Terminate the License Once Bankruptcy Begins

A debtor in possession or trustee generally may assume or assign a contract or lease despite default provisions triggered by the debtor's bankruptcy filing, insolvency, or poor financial condition, or appointment of a trustee or custodian, which would otherwise permit the termination or modification of the contract or lease by the nondebtor party.33 These are commonly referred to as "ipso facto" provisions. Contract provisions may also be unenforceable as ipso facto violations when they give rise to defaults that are inherent in a bankruptcy setting, even though they do not expressly refer to a debtor's financial condition.34 To the extent a license of IP contains enforceable anti-assignment provisions, however,

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32. See Id. § 9-102(a)(75).
34. See, e.g., In re Tobago Bay Trading Co., 112 B.R. 463, 466–67 (Bankr. N.D. Ga. 1990) (lease provision prohibiting tenant's liquidation sale was invalid); In re Garnas, 38 B.R. 221 (Bankr. D.N.D. 1984) (nonrenewal of insurance policy based on debtor's financial problems); In re B. Siegel Co., 51 B.R. at 164 ("terminable at will" provision in insurance policy surprisingly interpreted as unenforceable ipso facto clause within the scope of section 365(e)(1)).
see Section IV, infra, as well as ipso facto provisions that are grounds for termination or modification of the license, the court may grant relief from the automatic stay to permit the nondebtor to exercise those rights or may determine that the automatic stay does not apply. 35

B. Practice Tips

1. Terminate the IP license prior to bankruptcy. If termination for insolvency is desired, clearly define insolvency-related defaults in the license agreement.

2. If there is any dispute, file a motion or other proceeding in the bankruptcy court to determine that the termination was effective prepetition.

3. If termination of the IP license is desired after bankruptcy, file a motion to shorten the time for assumption or rejection of executory contracts under section 365(d)(2), for a determination that the license may not be assumed or assigned under section 365(c)(1), or for relief from the automatic stay under section 362(d).

4. If payments by the trustee or debtor in possession are not made after bankruptcy, file a request for allowance and payment of an administrative expense under section 503(b)(1)(A) or to compel assumption or rejection of the license under section 365(d)(2). Although the law is unsettled as discussed above, the licensor may also wish to consider filing a request for allowance and payment or filing a proof of claim asserting priority for deliveries made to or IP used by the debtor in the ordinary course of its business in the 20 days before bankruptcy, following any special procedures that the bankruptcy court may have established for such claims.

5. If actions by the trustee or debtor in possession are required to protect the nondebtor’s interests during the bankruptcy, file a motion for adequate protection.

6. Be vigilant during the case and object to financing motions, sale motions, Chapter 11 plans, or other actions by the trustee or debtor in possession to the extent they violate the nondebtor’s

35. In re Footstar, Inc., 337 B.R. 785 (Bankr. S.D.N.Y. 2005) (holding that nondebtor party to executory contract was not entitled to enforce ipso facto clause where debtor did not intend to assign license); Watts v. Pa. Hous. Fin. Co., 876 F.2d 1090, 1096 (3d Cir. 1989) (holding that where an ipso facto clause is enforceable, the nondebtor party may terminate the contract without violating the automatic stay).
IP rights. Asset sale transactions often involve “transition services agreements,” under which the buyer will have temporary access to the debtor’s IP licenses pending designation for assumption or rejection of the license or negotiation of a new agreement with the licensor.\(^{36}\)

### III. Is a License an Executory Contract?

#### A. General Principles

Only contracts that are executory may be assumed, assigned, or rejected under section 365 of the Bankruptcy Code. The Bankruptcy Code does not define “executory.” Bankruptcy courts most often cite the definition developed by Professor Vern Countryman for whether a contract is executory. Under the Countryman definition, a contract is executory where both the debtor and the nondebtor parties have unperformed obligations such that failure of either to complete performance would constitute a material breach excusing the performance of the other.\(^ {37}\)

As a rule, nonexclusive licenses of IP are considered executory contracts, whereas exclusive licenses are not.\(^ {38}\) Whether sufficient performance remains due on both sides for the contract to be executory is frequently a difficult question. Negative covenants have been determined to be sufficient to make a contract executory.\(^ {39}\) Even the

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36. See In re RS Legacy Corp. (f/k/a RadioShack Corp.), Case No. 15-10197 (Bankr. D. Del.), Order Authorizing (I) the Sale of Certain Assets of the Debtors Free and Clear of All Claims, Liens, Liabilities, Rights, Interests and Encumbrances; (II) the Debtors to Enter into and Perform Their Obligations Under the Asset Purchase Agreement and Certain Ancillary Agreements; (III) the Debtors to Assume and Assign Certain Executory Contracts and Unexpired Leases; and (IV) Granting Related Relief, Docket No. 1672.

37. Vern Countryman, Executory Contracts in Bankruptcy: Part I, 57 MINN. L. REV 439 (1973). See also In re Texscan, 976 F.2d 1269 (9th Cir. 1993); In re Select-A-Seat Corp., 625 F.2d 290 (9th Cir. 1980); In re Coast Trading Co., Inc., 744 F.2d 686, 692 (9th Cir. 1984).

common license agreement provision prohibiting the parties from suing for infringement has been construed as sufficient for a license agreement to remain executory.\textsuperscript{40}

B. Practice Tip

It is extremely difficult for nondebtor licensees to prevent rejection based on lack of executory duties. However, see infra as to section 365(n) protections for licensees.

IV. Can a License Be Assigned to a Third Party by a Bankruptcy Trustee or Debtor in Possession?

A. General Principles

An executory contract must first be assumed in order to be assigned under section 365 of the Bankruptcy Code. Absent consent by nondebtor patent, copyright, or trademark licensors, both assumption and assignment are prohibited in many circuits. Even in circuits where assumption may be permissible, assignment will be prohibited unless the licensor consents.


Assignment of a lease or contract relieves the bankruptcy estate of liability for any future breach.\textsuperscript{41} A trustee or debtor in possession may usually assign an executory contract or unexpired lease regardless of anti-assignment provisions.\textsuperscript{42} If anti-assignment provisions are to be overridden, the trustee or debtor in possession must first assume the contract or lease, including provision for cure of defaults, and, as discussed previously, provide adequate assurance of performance by the assignee regardless of whether there had been a previous default.\textsuperscript{43}

\textsuperscript{40} In re Access Beyond Tech., Inc., 237 B.R. 32, 43–44 (Bankr. D. Del. 1999) (citing Everex Sys., Inc. v. CadTrak Corp. (In re CFLC, Inc.), 89 F.3d 673, 677 (9th Cir. 1996)).

\textsuperscript{41} 11 U.S.C. § 365(k).

\textsuperscript{42} Id.§ 365(k).

\textsuperscript{43} Id.
Courts have construed contract provisions as the equivalent of unenforceable anti-assignment clauses where the effect of the provision is to restrict assignment.\textsuperscript{44}

2. Licenses Are Inherently Nonassignable without Licensor Consent

The general rule is that a debtor in possession or trustee may not assign an executory contract if applicable law would excuse the nondebtor party from accepting performance or rendering performance to the trustee or assignee, and the nondebtor party does not consent to assumption or assignment. This prohibition will generally include personal service contracts.\textsuperscript{45} Applicable nonbankruptcy law, such as government regulations barring assignment of particular contracts, may also preclude assignment.\textsuperscript{46} Inherent nonassignability is a major issue with IP licenses. Many cases have addressed whether the licensee's interest in a patent, copyright, or trademark license can be assigned. Courts have opined that contracts in which the debtor is the licensee of a patent are inherently nonassignable under federal common law absent the licensor's consent.\textsuperscript{47} The Ninth Circuit reached the same conclusion for copyright licenses.\textsuperscript{48} It is possible that the logic of these cases could also be applied to licenses involving trade secrets and other confidential information. Some

\textsuperscript{44} See, e.g., \textit{In re Standor Jewelers West, Inc.}, 129 B.R. 200, 201–02 (9th Cir. B.A.P. 1991) (lease provision requiring remittance to lessor of proceeds of assignment deemed invalid under section 365(f)); \textit{In re Peaches Records & Tapes, Inc.}, 51 B.R. 583, 590 (9th Cir. B.A.P. 1985); \textit{In re Vista VI, Inc.}, 35 B.R. 564, 567–68 (Bankr. N.D. Ohio 1983) (invalidating provision requiring tenant to operate under specific trade name).

\textsuperscript{45} See, e.g., \textit{In re Tonyx}, 724 F.2d 467 (5th Cir. 1984) (contingent fee contract of lawyer), \textit{But see In re Cardinal Indus.}, 116 B.R. 964 (Bankr. S.D. Ohio 1990) (trustee can assume personal service contract if performance to be by debtor).

\textsuperscript{46} See, e.g., \textit{In re West Elec., Inc.}, 852 F.2d 79 (3rd Cir. 1988) (nonassignable government contract); \textit{In re Pioneer Ford Sales, Inc.}, 729 F.2d 27 (1st Cir. 1984) (franchise agreement where state law prohibited transfer without manufacturer's consent); \textit{In re Braniff Airways, Inc.}, 700 F.2d 935 (5th Cir. 1983) (restricted airport gate slots); \textit{In re Ntec Paper Corp.}, 43 B.R. 452 (S.D.N.Y. 1984) (special, low-rate electricity supply contract).

\textsuperscript{47} \textit{In re Alltech Plastics, Inc.}, 71 B.R. 686, 689 (W.D. Tenn. 1987); \textit{see Warren E. Agin, Bankruptcy and Secured Lending in Cyberspace, 3d Ed. §§ 7:26–7:34 (West 2011)}.

\textsuperscript{48} \textit{Harris v. Emus Records Corp.}, 734 F.2d 1329 (9th Cir. 1984) (citing patent cases by analogy); Everex Sys., Inc. v. Cadrax Corp. \textit{(In re CFLC, Inc.)}, 89 F.3d 673 (9th Cir. 1996) (nonexclusive prepaid patent license not assignable in bankruptcy); \textit{In re Catapult Enter'ts.,} 165 F.3d 747, 749–50 (9th Cir. 1999) (nonexclusive patent license). \textit{See also In re Trump Enter't Resorts, Inc.}, 526 B.R. 116 (Bankr. D. Del. 2015) (holding that a debtor in possession may not assume an executory contract over the nondebtor's objection if applicable law would bar assignment to a hypothetical third party).
cases address whether exclusive as well as nonexclusive licenses are inherently nonassignable without consent. Federal common law holds that a trademark licensor’s consent is required to transfer or sublicense a trademark license; thus, a trademark license is nonassignable in bankruptcy.

For debtors, trustees, and secured creditors, this “inherent non-assignability” is a major factor. As many high-tech and telecom bankruptcies involve liquidations, inherent nonassignability can be significant. Even liquidation of computer hardware can trigger an objection to transfer of software contained or included in the equipment. However, just because a licensor can hypothetically block assignment does not mean the licensor will not consent to assignment. Licenses often contain conditional assignment rights that are much broader than the limited right to assign the license to affiliates or at the discretion of the licensor. Obtaining such assignment consent in the license is important not only for the licensee, but also for any secured lender relying on the existence of the license rights for its perceived collateral value.

B. Practice Tips

1. Be vigilant and object to any motion to assign a license or to a Chapter 11 plan that calls for such an assignment.

2. Define in the license agreement what constitutes adequate assurance of future performance, such as net worth, capital requirements, performance benchmarks, noncompete clauses, and scope limitations. Provisions must be applicable to the original licensee as well as any permitted assignee. This may provide the court with a minimum standard favorable to the licensor based on the contract itself, instead of having to fashion


one on an ad hoc basis from extrinsic evidence and impose an undesirable licensee on the licensor.

3. Keep in mind that the type of IP that is licensed and the specific terms of a license, particularly on the issue of assignability, may alter the general no assignment rule.

V. The "Catapult Problem": Can an IP License Ever Be Assumed by a Bankruptcy Trustee or Debtor in Possession without Consent?

A. General Principles

Where the debtor licensee would like to continue to use IP that it has licensed from others to continue its business, the licensee will seek to assume the license. In the majority of federal circuits, where assignment of an IP license is prohibited without the consent of the licensor, the debtor in possession or trustee will usually be precluded from even assuming the license, even when no assignment to a third party is contemplated. In other words, in bankruptcy, by withholding its consent, the licensor can prevent the licensee from keeping the license even for the licensee's own use.

Given the presumption that a Chapter 11 debtor will reorganize and retain its assets, the mere filing of a Chapter 11 petition alone arguably does not implicate the federal policy of "inherent nonassignability" of patent or copyright licenses, regardless of theoretical arguments that the bankruptcy filing creates a transfer to the bankruptcy estate. Thus, the creation of a Chapter 11 bankruptcy estate does not, by itself, create a transfer to the trustee or debtor in possession that should trigger anti-assignment concerns. However, 11 U.S.C. § 365(c) provides the following:

(c) The trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if
(1)(A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession whether or not such contract, or lease, prohibits or restricts assignment of rights or delegation of duties; and

(B) such party does not consent to such assumption or assignment.

A literal reading of the statute leads to the so-called hypothetical test, which holds that if an executory contract may not be assigned under applicable nonbankruptcy law, then it cannot be assumed by the trustee or debtor in possession. This requires courts to decide whether, under applicable law, assignment to a third party would be forbidden. A less literal reading of the statute has led some courts to look to whether actual assignment will occur (the "actual", as opposed to hypothetical, test). Until the split in the circuits regarding nonassignability of inherently nonassignable contracts is resolved by Congress or the U.S. Supreme Court, absent consent of the licensor, a Chapter 11 debtor in at least the Third, Fourth, Ninth, and Eleventh Circuits may not assume a copyright or patent license in which the debtor is licensee. The First Circuit, on the other hand, follows the "actual" test. At least one bankruptcy judge in the Southern District of New York also follows the "actual" test, but

51. See In re Sunterra Corp., 361 F.3d 257 (4th Cir. 2004) (holding debtor in possession was precluded from assuming nonexclusive copyright license even though debtor in possession did not intend to assign it); Cinicola v. Scharffenberger, 248 F.3d 110, 126 (3rd Cir. 2001); In re Catapult Entm't, 165 F.3d at 749–50 (adopting hypothetical test); Allenstown Ambassadors Inc. v. Northeast Am. Baseball LLC, 361 B.R. 422 (Bankr. E.D. Pa. 2007) (recognizing binding authority of hypothetical test in Third Circuit, but finding that "applicable law" of state limited liability company act did not excuse performance under operating agreement);  In re Catron, 158 B.R. 629, 638 (E.D. Va. 1993) (same), aff'd without opinion, 25 F.3d 1038 (4th Cir. 1994).

applies "a different focus" where the debtor in possession has no intent to assign the license. That court's analysis distinguishes between the debtor in possession and the trustee in holding that the debtor in possession is not subject to limitations on assumption of an executory contract because the performance will be coming from the debtor—the same as if no bankruptcy petition had been filed.\textsuperscript{53}

Two factors are important in avoiding the potentially harsh effects of section 365(c)(1). First, consent by the licensor avoids the problem. If the licensor has conditionally consented to assignment in the license itself, the license should be assumable and assignable, subject to satisfying the assignment conditions. Secondly, although section 365(c)(1) may prohibit assumption or assignment without the licensor's consent, it does not compel rejection at any specific date. This allows the estate to utilize the license during the potentially lengthy limbo period, unless the licensor can convince the court that rejection should be compelled early.\textsuperscript{54} It is important to note, however, that at least the Bankruptcy Court for the District of Delaware has held that the \textit{Catapult} problem cannot be avoided by attempting to sell the license without assumption because, until assumed, an executory contract is not an asset of the estate and cannot be sold.\textsuperscript{55}

Even if the debtor in possession or trustee is able to overcome the restrictions of section 365(c)(1) of the Bankruptcy Code, it still may not assume the license unless the bankruptcy estate provides cure or adequate assurance of prompt cure of any existing defaults (except unenforceable ipso facto provisions discussed in Part II-A-5 above); compensates the nondebtor party for loss resulting from the default; and provides adequate assurance of future performance under sections 365(b)(1) and (f)(2)(B).

The term "adequate assurance" is not defined in the Code; however, most courts have held that the term was intended to be given a practical,

\textsuperscript{53} \textit{In re Footstar, Inc.}, 323 B.R. 566, 570–74 (Bankr. S.D.N.Y. 2005) (holding that section 365(c)(1)(A) does not preclude assumption by debtor in possession where no assignment to third party is intended). \textit{But see In re Taylor Inv. Partners II, LLC}, 533 B.R. 837, 842–43 (Bankr. N.D. Ga. 2015) (holding that section 365(c)(1) would prevent a debtor in possession from assuming an executory contract if applicable law would excuse the other party from accepting performance from a party other than the debtor in possession). No reported decision indicates whether or how either test applies to a trade-secret license. \textit{See Sandeen, supra note 1, at 113.}

\textsuperscript{54} \textit{See, e.g., In re Valley Media}, 279 B.R. 105 (Bankr. D. Del. 2002).

\textsuperscript{55} \textit{In re Access Beyond Tech.}, 237 B.R. at 47.
pragmatic construction.68 Simply put, the test is whether the debtor has established a foundation that is nonspeculative and sufficiently substantive to warrant the reasonable conclusion that the default will be cured and all obligations performed as required under the contract.67

B. Practice Tips

1. To address case law prohibiting assumption of IP licenses, the licensee will want the license to allow assumption or retention of the license in a bankruptcy proceeding, even when the license prohibits or restricts assignment. The licensor might limit a “consent to assumption” provision to situations that do not involve any actual change of control over the licensee.

2. The debtor licensee will want to ensure that the licensor consents to assumption and assignment. Prior to filing for bankruptcy, the debtor should review all of its licenses to determine those that require licensor consent. If consent is required and licensor is unwilling, the debtor licensee may wish to consider alternatives to bankruptcy, and if bankruptcy is necessary, whether a venue that applies the actual test is available.

3. The nondebtor licensor should be vigilant and object to a Chapter 11 plan or motion to assume the license to the extent that such an objection makes business sense. An assumption may actually be good for a licensor who wishes to have defaults cured rather than deny ongoing use to the debtor in possession or trustee. In that case, the licensor should confirm that the cure amount to be paid in connection with assumption is accurate and is to be paid promptly.

4. It remains to be seen whether the patent reform of 2011 under the Leahy-Smith America Invents Act has any effect on owners, assignees, or buyers of patents in bankruptcy. There are no specific references to bankruptcy law in the act; however, certain aspects of the reform could impact the bundle of rights that owners, assignees, or buyers of patents have, and further analysis may be warranted.


VI. What Happens if a License Is Rejected by a Trustee or a Debtor in Possession?

A. General Principles

1. Rejection Is Subject to the Business Judgment Test

Executory contract rejection is automatic in Chapter 7 liquidation cases if the trustee does not assume the contract within 60 days or such further period as extended by court order. Except for automatic rejection in Chapter 7 cases, the bankruptcy court must approve a request by the debtor in possession or trustee to reject an executory contract. The standard generally followed is the so-called business judgment test. Under that test, rejection is a management decision within the reasonable business judgment of the debtor or trustee and will not readily be second-guessed by the court.58

Although the business judgment test is typically construed as extremely deferential to the trustee or debtor in possession, where rejection would be provably detrimental to the estate or the benefits of rejection extremely speculative, the court may disapprove.59 Some courts occasionally have also considered the disproportionate impact of rejection on the nondebtor party in comparison to any asserted benefit to the bankruptcy estate.60 Similarly, courts will refuse to allow rejection for an improper purpose.61

Section 365(n) of the Bankruptcy Code (as discussed infra) may limit the reasonableness of rejection. In Matusalem & Matusa of Florida,


59. See, e.g., In re Midwest Polychem, Ltd., 61 B.R. 559 (Bankr. N.D. Ill. 1986) (resulting large claim for rejection eliminates any business rationale); In re Myklebust, 26 B.R. 582 (Bankr. W.D. Wis. 1983) (benefits of rejection of mineral lease "speculative"); but see In re Pilgrim's Pride Corp., 403 B.R. 413, 427 n.34 (Bankr. N.D. Tex. 2009) (not ruling out ever considering harm to debtor's counterparty, but determining it inappropriate under facts of particular case).


61. See, e.g., In re Waldron, 785 F.2d 936 (11th Cir. 1986) (bad-faith dismissal of Chapter 13 by bankruptcy lawyer filed for purpose of rejecting unprofitable option agreement); In re Noco, Inc., 76 B.R. 839 (Bankr. N.D. Fla. 1987) (solvent debtors filed case to reject covenant not to compete; franchise agreement had also been substantially performed and was therefore nonexecutory).
Inc., the debtor owned IP, including a secret formula and a trademark. The debtor sought to reject a franchise agreement, pursuant to which the franchisee/licensee enjoyed the exclusive right to use certain secret processes and formulas for the manufacture of rum products, the exclusive right to use the name “Matusalem” and related names for the sale of those rum products, and the exclusive right to manufacture, distribute, and sell those rum products in Puerto Rico, the United States, Central America, and South America. The franchisee paid an initial fee and had the obligation to pay royalties during the life of the agreement. The bankruptcy court found that the debtor had not been engaged in active business operations involving the distillation, distribution, or sale of rum products for about 12 years, yet the debtor was “seeking to begin a new speculative business venture by destroying its franchisee... and then operating a rum distillation and distribution company in the same manner as a managed health care business. The court is persuaded that this is not good business judgment.” Furthermore, the court found:

Even if rejection were permitted, it would not automatically result in the termination of [franchisee’s] exclusive rights to manufacture and sell these products within its territorial area. . . . Thus, rejection under Section 365(n) would not deprive [franchisee] of its rights under the franchise agreement. It would, however, make the [d]ebtor potentially liable for a rejection claim.

There would be no benefit to the estate; thus, the court denied rejection.

2. Rejection of One License May Constitute a Default under Another

Even prior to the enactment of the current Bankruptcy Code, executory contracts and unexpired leases had to be assumed in their entirety. A debtor in possession or trustee could not pick and choose those

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63. See Matusalem, 158 B.R. at 516.
64. Id. at 521.
65. Id. at 522.
portions it wished to enforce and those portions it wished to reject. However, the Ninth Circuit Bankruptcy Appellate Panel has held that a court may construe multiple obligations in an agreement as severable under state law, thus allowing assumption of specific obligations.\textsuperscript{67}

The requirement that executory contracts must be assumed in their entirety generally includes adherence to cross-default provisions.\textsuperscript{68} However, some courts have relied on equitable grounds in refusing to honor cross-default provisions. Such courts analogize particularly onerous cross-default provisions to unenforceable ipso facto and anti-assignment clauses.\textsuperscript{69}

3. \textit{Section 365(n) Provides Special Protection to Licensees of IP against the Impact of Rejection}

Given the harsh impact of rejection of executory contracts, certain classes of nondebtor parties have been provided with protection under the Bankruptcy Code, mitigating the effects of rejection. For example, where the debtor is a lessor of real property or time-share interests, the nondebtor lessee or time-share lessee has the option of treating the lease or time-share plan as terminated or, in the alternative, remaining in possession of the leasehold or time-share interest for the balance of the term and any renewal periods, provided the lessee or time-share participant pay the rent reserved under the lease or monies due under the time-share agreement for the balance of the term, less any damages for future nonperformance of obligations of the debtor. Special protection also exists for nondebtor real estate vendees.

In response to the harsh result in cases allowing rejection of IP contracts such as \textit{Lubrizol Enterprises, Inc. v. Richmond Metal Finishers,}


\textsuperscript{67} \textit{In re Pollock}, 139 B.R. 938 (Nth Cir. B.A.P. 1992).


\textsuperscript{69} See, e.g., \textit{In re Sambo's Rest., Inc.}, 24 B.R. 755 (Bankr. C.D. Cal. 1982) (court refused to enforce cross-default provisions applying to 10 separate leases of restaurant properties to the debtor); \textit{In re Wheeling-Pittsburgh Steel Corp.}, 54 B.R. 772 (Bankr. W.D. Pa. 1985) (court refused to enforce cross-default provisions in four insurance policies tied to delinquent fifth policy); \textit{affid.} 67 B.R. 620 (W.D. Pa. 1986); see also \textit{In re Madison's Partner Group, Inc.}, 67 B.R. 633 (Bankr. D. Minn. 1986) (court required showing of "special consideration" furnished by lessor to enforce cross-default tied to contract to which debtor was not a party).
Inc., Congress amended section 365 of the Bankruptcy Code to protect nondebtor licensees of "intellectual property" as that term is defined by the Bankruptcy Code. Thus, in the event of rejection, the nondebtor licensee may elect to treat the license as terminated or retain its license rights for the duration of the contract and any applicable extensions. If the licensee elects to retain its rights, it must make all royalty payments and waive claims and offset rights for prior nonperformance; however, the licensee cannot enforce obligations of the debtor to provide maintenance, technology updates, or other services.

Care should be taken in drafting IP licenses so that the royalty to be paid for retaining the IP does not include payment for services no longer performed by the debtor after rejection or for post-petition or post-rejection improvements or modifications. In addition, IP buyers—even those whose purchases are free and clear of liens—must be aware that such a sale may be subject to the section 365(n) rights of licensees even if those licenses are not assigned under the purchase agreement.

If the licensee retains its rights, the trustee must continue to provide it with any applicable IP held by the trustee and not interfere with the licensee's right to obtain such IP from another entity. Section 365(n) also requires the trustee or debtor in possession to continue to provide the licensee with the IP in the limbo period prior to rejection or assumption. For example, a licensee should be provided access to software source code held in escrow pursuant to a license even during the limbo period.

70. Lubrizol Enter., Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043 (4th Cir. 1985).
71. 11 U.S.C. § 365(n); see Agin, supra note 47, at §§ 7:36 to 7:46 (West 2011).
72. Significantly, the definition of "intellectual property" under the Bankruptcy Code, 11 U.S.C. § 101 (35a), does not include trademarks and, in light of language in the Defense Trade Secrets Act of 2016 (DTSA), arguably no longer includes trade secrets which, according to the DTSA, are not to be considered "intellectual property" for purposes of any other federal law.
74. In re CellNet Data Sys., 327 F.3d at 252 (requiring purchaser of IP rights from debtor to comply with rejected license obligations, whereas debtor remains entitled to royalty payments from licensee). Cf. Jon Minear, Your Licensor Has a License to Kill, and It May Be Yours: Why the Ninth Circuit Should Resist Bankruptcy Law That Threatens Intellectual Property Licensing Rights, 31 Seattle U. L. Rev. 107, 135 (2007) (suggesting that courts should require IP purchasers in "free and clear" sales to take title subject to "all encumbrances on the property" to protect nondebtor licensees).
75. See In re El Int'l, 123 B.R. 64, 66 (Bankr. D. Md. 1991) (holding that license was treated as terminated with damages calculated as if license were breached prepetition where licensee did not affirmatively elect to retain benefits).
76. Szombathy v. Controlled Shredders, Inc., No. 97 C 481, 1997 WL 189314 (N.D. Ill. Apr. 14, 1997). For more information on technology escrows and special-purpose entities to protect IP against adverse impacts in bankruptcy cases, see Agin, supra note 47, at Ch. 12.
retained rights to "such rights as existed immediately before the case commenced" is that the license must exist prepetition. The license cannot spring into existence post-petition pursuant to a prepetition contract term. 77 In addition, the protected rights do not include the right to future IP coming into existence post-petition.

There are also some limitations on the range of IP interests protected under section 365(n). Section 101(35) (A) of the Bankruptcy Code defines IP as including trade secrets, inventions, and works of authorship protected under title 17, but does not include trademarks or confidential or proprietary information not qualifying for trade-secret status. 78 Thus, a nondebtor licensee of trademarks is not protected under section 365(n) in the event of rejection of the license agreement. This is an important exclusion from section 365(n) protections. 79 As further discussed in Part VI-A-4, infra notes 86–87, there is a circuit split on the significance of this exclusion, which is anticipated to be resolved by the Supreme Court in 2019.

In addition, in the Seventh and Ninth Circuits, a licensee of IP may not be able to rely on section 365(n) to afford it protection in the event of a sale free and clear of liens and encumbrances. In a case that addressed the right of a lessee of real property to retain its rights under the lease following a sale "free and clear," the Seventh Circuit held that despite the protections granted by section 365(h), the lessee's interest was extinguished by a sale free and clear of liens and encumbrances under section 363(f). It stated, "Congress authorized the sale of estate property free and clear of 'any interest,' not 'any interest except a lessee's possessory interest.'" Like section 365(n), section 365(h) grants certain protections to lessees of real property, allowing them to remain in possession for the balance of the lease term following a rejection of the


78. For a more detailed examination of the consequences of these exclusions, see Nguyen, supra note 3; Sandeen, supra note 1, at 81.

79. In re Gucci, 126 F.3d at 394 (concluding that trademarks are not IP for the purposes of section 365(n)).
lease by the debtor/landlord.80 By analogy, the Seventh Circuit’s logic could be equally applicable to the interest of a licensee of IP to retain its rights under section 365(n). At least two bankruptcy courts have refused to follow the Seventh Circuit.81

Section 365(n) is applicable automatically in Chapters 7, 11, 12, and 13 of the Bankruptcy Code. It may also be applicable in the bankruptcy court’s discretion in a case under Chapter 15 of the Bankruptcy Code. Chapter 15 allows the foreign representative of an insolvency proceeding in another country involving a debtor with assets in the United States to file a petition in bankruptcy court for recognition of the foreign proceeding in the United States.82 In Chapter 15, the bankruptcy court may grant the foreign representative any additional relief that may be available to a bankruptcy trustee, including rights and duties under section 365, with certain exceptions particularly relating to avoidance actions.83 U.S. and foreign law may diverge. For example, German law permits the outright termination of a licensee’s rights in an insolvency proceeding by the debtor’s administrator in the position of the licensor, whereas under U.S. law, the bankruptcy court may determine that a license is merely subject to rejection and thus the protections of section 365(n), leaving the option of termination up to the licensee. In determining whether section 365(n) should apply in a Chapter 15

80. Precision Indus., Inc. v. Qualitech Steel SBQ, LLC, 327 F.3d 537, 548 (7th Cir. 2003). See also Pinnacle Rest. at Big Sky, LLC v. CH SP Acquisitions, LLC (In re Spanish Peaks Holdings II, LLC), 872 F.3d 892 (9th Cir. 2017) (allowing sale free and clear of lessee’s interest where lease had not been assumed or rejected, and no request for adequate protection had been made by lessee). The language of the sale order or other unique facts may be of crucial importance in determining whether a sale is free and clear of a license. See O’Brien v. 1st Source Bank, 866 N.E.2d 903, 908 (Ind. Ct. App. 2007) (affirming summary judgment that tenant remained bound by lease where bankruptcy court order approving sale did not affect sale free and clear of lease because language of order referred to “any adverse liens, encumbrance or other claims,” rather than “all liens, claims, encumbrances and interests” of them, as in Qualitech, and lease was not adverse to mortgagee bank that purchased mortgaged property and had assignment of rents under lease); see also In re R.J. Dooley Realty, Inc., No. 09-36777, 2010 WL 2076959, at *7–*8 (Bankr. S.D.N.Y. May 21, 2010) (holding that lessee as unsecured creditor was not entitled to demand adequate protection). See also Anthony Avello, The Sale of Real Property Free and Clear of a Lease: Making Sense of Sections 363(f) and 365(h) of the Bankruptcy Code, 24 A.M. BANKR. INST. L. REV. 279 (Summer 2016).

81. See In re Samaritan Alliance, LLC, No. 07-50735, 2007 WL 4162918, at *6 (Bankr. E.D. Ky. Nov. 11, 2007) (holding lessee’s possessory interest preserved by section 365(h) notwithstanding free and clear sale under section 363(f)); In re Haskell, L.P., 321 B.R. 1 (Bankr. D. Mass. 2005) (denying motion to sell where lessee could not be compelled to accept money satisfaction in evisceration of section 365(h)). But see In re MMH Automotive Group, LLC, 385 B.R. 347, 371–72 (Bankr. S.D. Fla. 2008) (holding that sale free and clear of lease is permissible under section 363(f)(5) where tenant agreed in contract to monetize value of leasehold interest).


83. See id. (citing 11 U.S.C. § 1521(a)(5), (7)).
case, the bankruptcy court must balance the interests of the debtor and the licensees as required by section 1522(a) of the Bankruptcy Code.\footnote{84}

Section 365(n) is irrelevant where the license is not actually an executory contract, such as an exclusive license as mentioned in Part III-A, supra. If a license is not executory, it may not be rejected, and the licensee continues to enjoy its rights under the license.\footnote{85} However, if a license is an executory contract that is not subject to the protection of 365(n), such as of a trademark, which is not included in the definition of "intellectual property" under the Bankruptcy Code, it is unclear what the effect of rejection would be on the licensee's rights. There is a circuit split as of January 2018, and results may vary by venue until the Supreme Court resolves the issue in 2019. The First Circuit holds that a licensor's rejection of a trademark license results in termination of the licensee's rights and leaves the licensee with only a prepetition claim for damages,\footnote{86} but the Seventh Circuit has affirmed that a licensor's rejection of a trademark license does not abrogate the licensee's contractual rights.\footnote{87}

\footnote{84} See Jaffé v. Samsung Elec. Co., 737 F.3d 14, 29 (4th Cir. 2013) ("We therefore conclude, through interpretation of § 1522(a)’s text and consideration of Chapter 15’s international origin, that the district court correctly interpreted § 1522(a)’s sufficient protection requirement as requiring a particularized balancing analysis that considers the ‘interests of the creditors and other interested entities, including the debtor,’ 11 U.S.C. § 1522(a), and, in this case in particular, a weighing of the interests of the foreign representative (the debtor) in receiving the requested relief against the competing interests of those who would be adversely affected by the grant of such relief (here, the Licensees). And we also agree that § 1506 is an additional, more general protection of U.S. interests that may be evaluated apart from the particularized analysis of § 1522(a)’"); see also In re Vitro S.A.B. de C.V., 701 F.3d 1031, 1060, 1067 n.42 (5th Cir. 2012). See also Derek I. Hunter, Nobody Likes Rejection: Protecting IP Licenses in Cross-Border Insolvency, 47 Geo. J. Int’l L. 1167 (2015–16).

\footnote{85} See In re Exide Tech., 607 F.3d 957, 964 (3d Cir. 2010); In re Interstate Bakeries Corp., 751 F.3d 955, 964 (8th Cir. 2014).


\footnote{87} See Sunbeam Prods. v. Chicago Am. Mfg., 686 F.3d 372, 378 (7th Cir. 2012). See also In re Exide Tech., 607 F.3d at 967 (Ambro, J., concurring) (asserting that there should be no negative implication that rejection terminates trademark licensee’s rights despite noninclusion of trademark in IP definition).
4. Rejection May Impact Rights of Secured Creditors in a License and Prior Transfers of Interests in the IP

Rejection of an executory contract does not retroactively void the agreement; it merely excuses the bankruptcy estate's future performance and creates a damage claim for breach of performance. Nonexecutory aspects of an agreement are not disturbed. Asset transfers completed prior to rejection are not generally affected. Thus, a security interest perfected prepetition survives regardless of later rejection of the lease or contract as to which the security interest was granted.88

Similarly, rejection does not terminate the nondebtor party's rights against nondebtor obligors or guarantors. Numerous courts have referred to section 365(n) to support the holding that rejection of an executory contract is not the equivalent of termination of such contract. Section 365(n) demonstrates this distinction because it plainly states that rejection does not result in termination unless the licensee elects to treat an interest as terminated.89

B. Practice Tips

1. Draft the original license agreement to expressly refer to and state that it is subject to section 365(n). The license agreement should also provide that the failure to perform continuing obligations constitutes a material breach of the contract excusing performance by the licensee, or otherwise define events

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constituting a material breach, to increase the likelihood that it will be considered an executory contract.

2. The license agreement should require the licensor to provide the licensee any IP and any embodiment of that IP held by the licensor, adequately described.

3. The license agreement should permit the licensee to provide the licensed IP to third parties without violating nondisclosure or exclusivity provisions in order to reduce the licensee's potential for continuing liability to the debtor or trustee and otherwise maximize rights that may be exercised notwithstanding rejection.

4. The license agreement should separate "royalty payments" made for the use of the IP itself from the payments made for other services. Alternatively, the license may provide for reduction of royalty payments in the event of nonperformance of maintenance, support, and upgrade provisions by the licensor. Trademark royalties should be spelled out separately and reduced in the event of nonperformance by the licensor.

5. The license agreement should require technology escrows and recovery of the escrowed materials during a bankruptcy case. In a technology escrow, the parties entrust essential information and data, such as source code, with a trusted third party.

6. The licensee may be able to create a disincentive to rejection through special termination fees or liquidated damage provisions accelerating payment of future royalties.

7. Whether a licensee or licensor, consider taking a security interest in the counterparty's interest in the IP.

8. A lender with a security interest in IP should obtain from the licensor an agreement to provide the lender with notice and opportunity to cure defaults, as well as permission to take an assignment of the license and to further assign the license to an eventual purchaser. The lender might also seek agreement from the licensor to enter into a replacement license if the borrower's license is rejected in bankruptcy. If a lender has been granted a security interest in the executory contract itself, this collateral is at risk in the event of rejection.

9. Be vigilant and prepared to object to a motion to reject the license, a motion to sell the underlying IP free of liens or interests, or the confirmation of a Chapter 11 plan so providing.
10. Rejection does not necessarily terminate the debtor in possession's or trustee's rights, including to sue the licensee for the licensee's breaches of contract.

11. Section 365(n) rights are subject to the rights of any creditor holding a perfected interest in the licensor's rights.

12. Section 365(n) rights may or may not be enforced in Chapter 15 cases.

VII. Can Assumption, Assignment, and Rejection Issues Be Avoided by "Ride-Through"?

A. General Principles

Some commentators have suggested the employment of a "ride-through" strategy to avoid the potentially harsh effects of the hypothetical test.90 This strategy is premised on the fact that the Bankruptcy Code contains no formal requirement that a debtor, debtor in possession, or trustee (as applicable, in cases other than under Chapter 7 of the Bankruptcy Code) reject or assume an executory contract, and involves simply allowing the contract to ride-through the bankruptcy without rejection or assumption, until it re-vests in the reorganized debtor.91

At least two bankruptcy courts have permitted the use of the ride-through strategy with respect to an exclusive patent license. In the case In re Hernandez, the court held that a license could ride-through and become binding on the reorganized debtor.92 In doing so, the court applied a four-factor test to determine whether a ride-through should

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91. As explained by the Fifth Circuit, "If an executory contract is neither assumed nor rejected, it will 'ride-through' the proceedings and be binding on the debtor even after a discharge is granted, thus allowing the non-debtor's claim to survive the bankruptcy." In re Nat'l Gypsum Co., 208 F.3d 498, 504 n.4 (5th Cir. 2000) (citing FederalK, Inc. v. Edmonton Inv. Co., 555 F.2d 577, 579 (6th Cir. 1977)). But see Tel Comm Tech., Inc. v. Toprani, No. CV030402999, 2008 WL 732647, at *5 (Conn. Sup. Ct. Feb. 28, 2008) (unreported decision) (dismissing contract claims of bankrupt debtor's assignee against nondebtor counterparty for lack of standing where contract was not properly assumed and assigned).

92. In re Hernandez, 287 B.R. 795 (Bankr. D. Ariz. 2002); In re Antone's Records, Inc. 445 B.R. 758, 772 (Bankr. W.D. Tex. 2011) (although executory contract "rode through" bankruptcy, creditor who failed to file proof of claim was not entitled to bring breach of contract action because nothing was owed by debtor as of filing of bankruptcy petition, and debtor received discharge under plan).
be permitted. The four factors are: (1) the damage that other parties to contracts would suffer, beyond compensation available under the Bankruptcy Code; (2) the importance of the contracts to the debtor's business and reorganization; (3) whether the debtor has had sufficient time to appraise its financial situation and potential value of its assets in formulating a plan; and (4) whether the exclusivity period has terminated.93 Similarly, in the case In re JZ, LLC, the court held that a license to manufacture and distribute a patented grinder rode through a completed Chapter 11 case.94

Other commentators have been warier of the ride-through strategy, noting that in some circuits the failure to formally assume an executory contract may be fatal, leaving the licensor with a post-confirmation argument that the license was rejected.95 Moreover, many contracts have ipso facto clauses, which although unenforceable under section 365(e)(1), cannot be avoided except through the assumption of the contract. Thus, in most situations, ride-through may not be possible. In particular, under the 2005 changes to the Bankruptcy Code, ride-through is expressly not available to individual debtors who are lessees under unexpired personal property leases.96

B. Practice Tips

1. To reduce uncertainty, ensure that the license is definitively dealt with in bankruptcy, either through assumption or rejection.
2. Consider the “ride-through” strategy in circuits where the hypothetical test is employed.

93. Hernandez, 287 B.R. at 806. The test employed by the court was originally set out by the Second Circuit in Theatre Holding Corp. v. Mauro, 681 F.2d 102 (2d Cir. 1982), to determine whether a debtor should be allowed to delay the assumption or rejection of an executory contract. See In re Adelphia Commc'ns Corp., 291 B.R. 283, 292 (Bankr. S.D.N.Y. 2003) (noting that Theatre Holding factors were developed and applied to unexpired lease of nonresidential real property prior to amendment of section 365(d)(4), shortening time to assume or reject this type of lease, but that otherwise determination of enlargement of time is left to court's discretion).
94. In re JZ, LLC, 357 B.R. 816 (Bankr. D. Id. 2006), aff'd, 371 B.R. 412 (9th Cir. B.A.P. 2007). A debtor may also enjoy a temporary form of ride-through: it need not always assume or reject an executory contract prior to confirmation, and may do so post-confirmation pursuant to a mechanism in a plan. See DJS Properties, L.P. v. Simplot, 397 B.R. 493, 501 (D. Id. 2008).
95. See, e.g., David R. Kuney, Intellectual Property Law in Bankruptcy Court: The Search for a More Coherent Standard in Dealing with a Debtor's Right to Assume and Assign Technology Licenses, 9 Am. Bankr. Inst. L. Rev. 593, 636 (citing Sea Harvest Corp. v. Riviera Land Co., 864 F.2d 1077, 1079 (9th Cir. 1989)) (the statutory presumption of rejection, unless the debtor or trustee acts affirmatively to assume a lease, protects the estate from unexpected liability).
VIII. When Is It Necessary to Request the Appointment of a Consumer Privacy Ombudsman?

A. Inspiration for Consumer Privacy Ombudsman

The idea for a consumer privacy ombudsman arose out of the bankruptcy case of *In re Toymart.com, LLC*. In that case, the debtor in possession sought to sell information about its customers to a third party, notwithstanding the debtor's privacy policy providing that it would never share such information. The Federal Trade Commission (FTC) sought to stop the debtor's sale. The dispute with the FTC was ultimately settled, and the transfer was permitted upon the debtor's agreement to provide notice to its customers and a right to opt out of the transfer. However, a number of state attorneys general continued to object to the sale, leading to the withdrawal of the data from the sale and its destruction.

B. Statutory Role and Appointment of Consumer Privacy Ombudsman

1. Condition to Sale Approval

Normally, the use, sale, or lease of property of the estate other than in the ordinary course of business as a statutory matter merely requires notice and a hearing. However, where the property at issue is personally identifiable information, and the debtor, in connection with offering a product or service, discloses to an individual a policy prohibiting the transfer of personally identifiable information about individuals to persons that are not affiliated with the debtor, and if such policy is in effect on the commencement of the case, a sale or lease must be consistent with that policy. As an alternative, the debtor must request the appointment of a consumer privacy ombudsman, and thereafter the court, upon notice and hearing, approves the sale or lease looking at the facts, circumstances, and conditions and finding that there is no showing that the sale or lease would violate applicable nonbankruptcy law.

What constitutes personally identifiable information is set forth in detail in the Bankruptcy Code. As a threshold matter, it must be provided by an individual to the debtor in connection with obtaining a product or service from the debtor primarily for personal, family, or household purposes. It includes the following types of information provided in that context: first and last name, physical address, electronic address, residential telephone number, Social Security number, account number, birth-related details, and any other information that will result in contacting or identifying the individual.

2. Appointment of Consumer Privacy Ombudsman as Professional of Debtor’s Estate

If a hearing is needed because the proposed transfer of personally identifiable information is inconsistent with the privacy policy, the debtor must seek the appointment of the consumer privacy ombudsman so that one is appointed by the U.S. trustee at least five days prior to the hearing. The ombudsman must be given notice of the hearing and is tasked at that hearing with providing information to the court about the debtor’s privacy policy, potential losses and gains to consumers if information is transferred, a related cost-benefit analysis, and potential alternatives to mitigate costs and losses.

3. Notice and Appointment Process

The process for seeking approval of the sale or lease of personally identifiable information and the appointment of the consumer privacy ombudsman is governed by Federal Rules of Bankruptcy Procedure 2002(c) and 6004(g). In the notice of hearing on the sale motion, the debtor or trustee must disclose whether the proposed sale or lease of personally identifiable information is consistent with any policy prohibiting its transfer.

In the motion to approve the sale or lease of personally identifiable information, the debtor or trustee must request that the U.S. Trustee be ordered to appoint a consumer privacy ombudsman. This requirement does not include an express exception for sales or leases consistent with a privacy policy. The motion must be served as a contested matter.

100. For further information on personally identifiable information, see Chapter 16.
102. See id. at § 332.
with a copy given to the U.S. trustee. The rule appears to contemplate that the U.S. trustee will appoint the ombudsman without waiting to be ordered to do so at the sale or lease hearing because the notice of appointment of the ombudsman must be filed five days before the sale or lease hearing. Presumably the appointment will be no surprise to the ombudsman because the ombudsman must file a disclosure of connections to parties in interest in the case at the same time the notice of appointment is filed.\textsuperscript{104}

C. Practice Tips

1. There is a dearth of reported opinions on the appointment of consumer privacy ombudsmen. The requirement is probably more often honored in the breach or is overcome where no party raises an objection that the procedure is not being followed. However, the effect of failing to have the ombudsman appointed has not been litigated, and there are the risks that a noncompliant sale or lease could be invalid or that the FTC or state attorney general could bring an enforcement action after the fact. To minimize the chances of such a collateral attack, it is advisable to request the appointment of an ombudsman.

2. Practitioners should be cognizant of the need to follow the procedure for appointment of the ombudsman and communicate with the U.S. trustee in that process. There must be sufficient time for the ombudsman to be appointed, make disclosures, and issue a report. This may be extremely challenging where the sale or lease requires emergency approval.

3. In the experience of practitioners who have served as ombudsmen or otherwise are aware of the few unreported cases where one has been appointed, the ombudsman has generally supported approval of a sale where: (1) purchasers would be in the same business or operate the same business as the debtor; (2) purchasers would be the debtor's successor in interest and/or will have to continue to comply with the debtor's prior

\textsuperscript{104}. Id. at 6004(g).
security and privacy policies; and (3) customers are provided an opportunity to opt in or out of the transfer.

4. The findings of fact supporting a sale order should include that a consumer privacy ombudsman was appointed in accordance with section 332 of the Bankruptcy Code and that, after due consideration of the facts, circumstances, and conditions of the transaction, as well as the report of the consumer privacy ombudsman filed with the court, there was no showing that sale of the personally identifiable information under the order would violate applicable nonbankruptcy law.

5. The consumer privacy ombudsman may be entitled to employ separate legal counsel at the expense of the debtor's bankruptcy estate.

6. A consumer privacy ombudsman is a party in interest with standing to object to actions that would affect his or her constituency, such as the closure of a Chapter 11 debtor's hospital.

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105. See also In re Escada (USA) Inc., No. 09-15008 (SMB), 2010 WL 4916435 (Bankr. S.D.N.Y. Jan. 7, 2010) (finding no consumer privacy ombudsman need be appointed in that scenario).


CHAPTER 18

Intellectual Property Issues in Real Property Transactions

Kimberly Y. W. Holst*

1. Introduction

While law students learn the basics of real estate law with formulas like "O conveys to A in fee simple absolute," attorneys who deal in real estate transactions know that real estate deals are rarely that simple. These deals often involve issues that are ancillary to the transfer or lease of the property.

One set of ancillary issues that may impact a real estate transaction concerns the intellectual property (IP) rights that often attach to real property. By identifying existing or potential IP issues early in a real estate transaction, attorneys can save themselves (and their clients) valuable time and money. In addition to exposing clients to potential liability, IP rights may present opportunities for additional revenue if the appropriate steps are taken to protect the IP assets.

This chapter provides attorneys with an overview of the different types of IP issues that can arise in real property transactions. It begins with a brief discussion of the types of IP claims that have been brought against property owners. Next, it discusses how business attorneys and their clients can identify whether any IP-related rights are associated with

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a given piece of real property. The chapter concludes with a discussion of strategies that may be employed to address the identified IP issues.

The details relating to the transfer, protection, and termination of IP rights require careful analysis of the subject facts and is beyond the scope of this chapter (although some information concerning such matters is provided in Chapters 5 and 10). Accordingly, an IP attorney should be consulted as necessary to help evaluate whether further action must be taken to determine if IP rights have been properly protected, terminated, transferred, or avoided. Additionally, a tax expert should be consulted to determine the tax implications relating to the subject real property and its associated IP rights.

Traps for the Unwary

1. IP claims may arise in any type of real estate transaction, including sales and short- or long-term leases.
2. Copyright protection for an architectural work may attach to a building and may impact the ability of a purchaser to construct a similar or identical building.
3. Copyrights in architectural works, including plans and drawings of such works, need not be registered with the U.S. Copyright Office to be valid. However, registration is required to make certain claims for damages in an action to enforce the copyrights.
4. Trademark rights can exist in a building or in assets related to the building, such as signs, billboards, and awnings. The building's exterior appearance or interior dress may be protected under trademark law.
5. Design patent protection may protect ornamental elements of a building or structure and may impact the ability to create substantially similar designs on additional structures or buildings elsewhere on the property.
6. Protection for works of visual art may limit a building owner's ability to renovate or destruct the building if doing so would cause damage, alteration, or destruction of a protected work located in the building or on the real property.
II. Overview of Risks Associated with Failing to Identify and Secure IP Rights Associated with Real Estate

At first glance, it may seem unlikely that IP rights would be an issue in real property transactions; however, there are a number of ways that IP rights may present themselves in these transactions. The following is a brief description of six ways that IP issues can arise in real estate transactions and some of the risks associated with a failure to recognize such issues. More details concerning these and related issues are provided in subsequent sections of this chapter.

A. A Building May Be Protected by Copyright Law

IP rights may be vested in a building itself. Under changes to U.S. copyright law that were adopted in 1990, a building may constitute the embodiment of an "architectural work" and, therefore, be protected by copyright law. As a result, the purchaser of a building that is protected by copyrights would be precluded from creating a neighboring building with a substantially similar or identical design without the permission of the copyright holder (typically the architect of the building).

Additionally, copyright protection might extend to the likeness of a building or architectural plans used in promotional materials or similar

items. This, in turn, may complicate the purchaser's plan to create a business complex identified by structures that are similar in appearance, or it may require the copyright holder to be diligent in searching for and identifying instances of potential infringement by others.

B. The Appearance of a Building May Be Protected by Trademark Law

Under certain circumstances, a building may be protected by trademark law. Pursuant to U.S. common law and federal statutes, if the exterior or interior features of a building are sufficiently distinctive so they serve as an indicator of a business's products and/or services, trademark and service mark rights will attach. Failure to identify these protected marks could spell trouble for a business owner who starts a business similar to the business previously housed on the property (e.g., the previous business was a restaurant with a recognizable and distinct building design, and the new business owner opens an unrelated restaurant but fails to change the recognizable design elements of the earlier business). The new business owner may find him- or herself as a defendant in a trademark infringement lawsuit due to the likelihood of confusion that may result from the use of the building.

C. The Trade Dress and Signage of a Building May Be Protected by Trademark Law

Trademark rights may also exist with respect to interior design elements of a building or in relation to assets incident to the sale of a building, such as the building's signage. As with the potential development of trademarks in the design of a building itself, trademark rights can develop in a building's trade dress if it is sufficiently distinctive to be recognized by consumers as a source of goods or services. A claim for trademark dilution may also be asserted where the owner of a protected
“famous” mark can establish that the alleged infringer's continued use of leftover signage harms the value of or disparages the protected mark.5

D. Visual Artists May Have Rights in Pictorial, Graphic, and Sculptural Works Incorporated into a Building or Located on the Building's Grounds

Under the Visual Artists Rights Act (VARA), visual artists have other rights in addition to traditional copyrights.6 Generally, VARA rights belong to the creator of the artwork and prohibit the alteration or destruction of artwork without the creator’s permission. Thus, a building owner may be prevented from destroying or remodeling a building if doing so would damage or alter protected works of visual art. See Chapter 10 for information on how to identify VARA rights.

E. Building Designs or Ornamentation May Be Protected by Design Patents

Design patents protect ornamental designs on a functional article. Ornamental design patents are governed by 35 U.S.C. § 171. In order to be protected under the statute, the protected design cannot have practical utility. The design patent precludes the creation or copying of a design that is substantially similar to the protected design. The duration of a design patent is 15 years from the date that patent is issued.7

F. There May Be Naming Rights or Other Rights Associated with a Building

Due to previous funding arrangements or desires to honor people living and dead, many buildings and parts of buildings have a name associated with them.8 Failure to carefully consider the implications with regard to naming rights could land a real property owner in court over contract disputes related to a variety of issues, such as benefits,
cost, ownership, duration, and more. Additionally, there may be other publicity considerations relating to the use of the building's image or advertising on or adjacent to the building.9

III. Identifying IP Rights Relating to Real Estate and Avoiding Infringement

The first step in dealing with IP issues associated with real estate transactions (and, indeed, any type of transaction) is to properly identify all applicable IP rights.10 However, identifying IP assets in real property transactions can range from obvious to nearly impossible, particularly when the purchaser or lessee is not supplied with the appropriate information. Some items are easily seen: Are there signs on the building that indicate trademarks or naming rights? Is there artwork installed on or in the building? Other items may not be so obvious: Is the building itself protected by design patents, copyrights, or trademarks?

Real estate attorneys already conduct a form of due diligence when entering a real estate transaction on behalf of their clients. Typically, they examine the title to the property and often the structure itself to determine potential issues that may arise in the transaction, such as claims related to property lines, easements, and the like. To determine whether IP rights may be an issue in the transaction, attorneys should be familiar with the various types of IP rights that exist, ask the other party whether any IP rights exist, and include searches of the federal patent, copyright, and trademark databases as a part of their due diligence process. Failing any of these steps, the attorney should consider including an additional agreement within each transaction outlining what will happen in the event that IP rights are discovered or asserted after the transaction is complete.

If possible, it is best to address potential IP rights early on in a purchase or lease agreement. Like any potential assets or drawbacks, the earlier such rights are identified, the easier it is to determine whether they add to or diminish the value of the real property assets and negotiate accordingly.

10. See Chapter 10 for a discussion of the documentary evidence of IP rights.
A. Identifying IP Rights in the Building Itself

As noted previously, in some circumstances, IP rights will exist in a building itself. This can include potential copyright, trademark, and patent rights. The copyright, trademark, and patent protections discussed in this part are based on the protections afforded under federal law. Trademark rights may also exist under individual state statutes or common law, and state-based "artist's rights" may apply.

1. Copyrights in Architectural Works

To better understand the interplay between copyright protection and real property, it is important to understand that ownership of the product that embodies protected copyrights does not constitute ownership of the copyrights themselves. To put this in a more familiar context, a person who purchases a painting does not acquire the copyrights in the painting by virtue of owning the painting. Instead, the artist retains the copyrights in the painting until those rights terminate under the law, are licensed, or are transferred pursuant to what is commonly known as a copyright assignment. In the context of real property, the owner or leaseholder of a building may have rights in the building, but any copyrights that exist in all or part of the building remain with the creator of the underlying work (often the architect) until they have been terminated, licensed, or assigned.

With the implementation of the Architectural Works Copyright Protection Act (AWCPA) of 1990, buildings became a medium in which architectural works protected by copyright could be embodied. Section 102 of the U.S. Copyright Act now includes architectural works in its list of works of authorship that may be the subject matter of copyright protection.

An architectural work is defined as "the design of a building as embodied in any tangible medium of expression, including a building, architectural plans, or drawings." It includes the overall form as well as the arrangement and composition of spaces and elements in the design, but does not include individual standard features. Significantly,
although the architectural drawings of buildings have long enjoyed copyright protection as "literary works," the AWCPA now also protects the buildings themselves.¹⁵

Under the 1976 Copyright Act, copyrights attach to a work (such as a building) at the time "an original work of authorship" becomes "fixed in a tangible medium of expression."¹⁶ This means that copyrights attach to a work at the time of creation and not at the time of registration—that is, copyright protection is automatic. Indeed, under U.S. and international law, registration of copyrights is not required to either acquire or maintain copyrights. However, since buildings are a relatively new form of a tangible medium of expression recognized by the Copyright Act, there are time limitations related to when copyrights attach to a building.

For the most part, buildings that were constructed or substantially constructed or plans that were published¹⁷ prior to December 1, 1990, are not eligible for copyright protection as architectural works.¹⁸ Care must always be taken under copyright law to determine when a qualifying work was created and whether copyrights in that work continue to survive as of the date of a real estate sale or other transaction involving those rights.

Due to provisions that were included in the AWCPA, the scope of copyright protection that is provided for architectural works is limited in two important respects. Section 120 of the U.S. Copyright Act provides:

(a) Pictorial representations permitted—The copyright in an architectural work that has been constructed does not include the right to prevent the making, distributing, or public display of pictures, paintings, photographs, or other pictorial representations of the work, if the building in which the work is embodied is located in or ordinarily visible from a public place.

(b) Alterations to and destruction of buildings—Notwithstanding the provisions of Section 6(2), the owners of a building

¹⁵. The Architectural Works Copyright Protection Act of 1990, which is Title VII of the Judicial Improvements Act of 1990, extended copyright protection to buildings constructed according to copyrighted architectural plans, whereas only the plans themselves were previously protected. This rule is further clarified in 37 C.F.R. § 202.11 (2017), which "prescribes rules pertaining to the registration of architectural works" 37 C.F.R. § 202.11(a).


¹⁷. An architectural work accomplishes publication when "the work is a pictorial, graphic, or sculptural work that is incorporated in a building or other structure, or an architectural work that is embodied in a building and the building or structure is located in the United States or a treaty party" 17 U.S.C. § 104(b)(4).

¹⁸. See 37 C.F.R. § 202.11. Note, however, that the written plans are likely to be protected as literary works.
embodying an architectural work may, without the consent of the author or copyright owner of the architectural work, make or authorize the making of alterations to such building, and destroy or authorize the destruction of such building. 19

Based on these limitations, the owner of a building generally has the right to make alterations to a building that is protected by copyrights or even destroy the building (but such right may be limited by VARA; see the discussion of VARA rights that follows). 20 Additionally, a building owner or leaseholder is not prohibited by copyright law from taking and distributing photos or making other pictorial representations of the building to be used in advertising and the like (but see the discussion of trademark rights that follows). 21

One potential pitfall with the foregoing limitations occurs when the building owner desires to create an identical or derivative building (e.g., the building owner wants to construct another building that looks identical to the purchased building). Given that the holder of the architectural works rights in the existing building has the sole right to "reproduce the copyrighted work in copies or...to prepare derivative works based upon the copyrighted work," 22 the new building cannot be constructed without the copyright holder’s permission. Therefore, the owner of the copyright in the architectural work (if it is not transferred or terminated) may act to enjoin the building owner from creating a new building if it would infringe on the copyrights in the existing building.

Although the U.S. Copyright Act includes a number of other exceptions to copyright liability, including the oft-referenced “fair use” exception, due to the highly fact-specific nature of those exceptions, it is often difficult for a building owner or its attorney to accurately predict whether or when those exceptions will apply. 23 Thus, the better practice is to acquire the architectural work copyrights along with ownership of the building or, at the very least, obtain a sufficiently broad license that

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20. H.R. Rep. No. 101-735, 101st Cong., 2d Sess. 18 (1990). In formulating this act, the House Judiciary Committee intended to protect the “poetic” language of architecture, which is “responsive to issues external to the building and incorporates the three-dimensional expression of the myths and rituals of society.” Id. at 19. This was opposed to “internal” architectural language relating to “pragmatic, constructional, and technical requirements.” Id.
21. Additional limitations apply for “[s]tate and local landmarks, historic preservation, zoning, or building codes, relating to architectural works protected under [the Copyright Act].” See 17 U.S.C. § 301(b)(4).
22. Id. § 106(1)(2).
23. See id. § 107.
will allow the building owner to engage in anticipated future projects. Of course, the owner of the copyright in the architectural work is likely to request compensation for granting such permission, or as is often the case, will condition the grant of permission upon being hired as the architect for the new building(s).

2. Trademarks

Trademark law is designed to protect consumers by providing them with confidence in identifying the source of a particular product or service. It is the potential likelihood for confusion in the design or appearance of a building that may give rise to trademark problems in the real property context. Therefore, it is important for building owners to know (1) whether any part of a building they own or want to purchase is protected (or protectable as a trademark), and (2) whether any part of a building they own or want to purchase infringes the trademark rights of another.

Trademark protection will become important at different times in the sale or lease of a building. A building owner that is selling or leasing a piece of real property that is protected by trademark law may want to emphasize the added value of such protection or, alternatively, suggest the need for the new owner or lessee to distinguish its business from the type of business that was previously operated in that space.

The purchaser or lessor of a piece of real estate should be interested in the trademark status of a building as well because the purchaser or lessor does not want to be accused of infringing on a previous owner’s trademarks by operating a similar business. (See Chapter 20 for a discussion of how these issues arise and can be solved in the franchise context.) Requiring distinguishing marks for the new business will prevent confusion among consumers in addition to protecting the rights of the owner of the trademark.

As explained in more detail in Chapter 1, the theoretical scope of trademark rights is quite broad. Although the definition of a trademark does not seem to implicate buildings, the U.S. Patent and Trademark Office (USPTO) and the courts have held that so-called trade dress may be entitled to treatment as trademarks under the Lanham Act, and that the interior and exterior designs of a building can constitute

protectable trade dress. Generally, trade dress "encompasses the design and appearance of a product along with all the elements that serve to identify the product to consumers." For the whole or any part of a building to serve as a protectable trademark, it must be established that it is "distinctive," either inherently or because it has acquired distinctiveness. Inherently distinctive trade dress is sufficiently unique so that it immediately (on first use) serves as an indicator for the source of a product or service. If trade dress is not inherently distinctive, then it may acquire distinctiveness over time by achieving what is known as a "secondary meaning."

Although it is not unheard of for courts or the USPTO to find the exterior or interior features of a building to be inherently distinctive, it is not likely because consumers are not prone to view buildings as trademarks. As case law has shown, it is difficult for buildings to obtain status as a trademark or service mark. The determination of whether a building has achieved the necessary distinctiveness to be deemed a trademark for a particular business, product, or service is intensely fact-specific. Additionally, courts will consider whether the elements of the building that implicate trade dress protection are necessary functional elements of the building's design. If the features of a building that are claimed as a trademark constitute functional design elements, they cannot be protected by trademark law.

There are three basic ways to determine whether trademark protection is likely to be an issue with regard to a building's trade dress. First, the records of the USPTO can be searched to see whether any

25. "[T]he Supreme Court interprets this Section [§ 43(a)] as having created a federal cause of action for infringement of unregistered trademark or trade dress and concludes that such a mark or trade dress should receive essentially the same protection as those that are registered." Two Pesos, Inc. v. Taco Cabana, Inc., 505 U.S. 763, 776 (1992) (Justice Stevens, concurring). See also Blau Plumbing, Inc. v. S.O.S. Fix-it, Inc., 781 F.2d 604 (7th Cir. 1986); Pub'ns Int'l Ltd. v. Landoll, Inc., 164 F.3d 337 (7th Cir. 1998).
27. See Two Pesos, 505 U.S. at 768-769.
29. See id. at 770-71.
31. See Two Pesos, 505 U.S. at 768-69; see, e.g., Rock & Roll Hall of Fame & Museum, Inc. v. Gentile Prods., 134 F.3d 749 (6th Cir. 1998); New York Racing Ass'n v. Perlmutter Pub'g, Inc., 959 F. Supp. 578 (N.D.N.Y. 1997); but see, e.g., White Tower, 90 F.2d at 67; Associated Hosts of Cal., Inc. v. Moss, 207 U.S.P.Q. 973 (W.D.N.C. 1979).
32. See Two Pesos, 505 U.S. at 775 (dicta).
aspects of a building have been registered as a trademark or service mark. Second, the seller or lessor of the building can be asked to make representations and warranties concerning the actual or potential trademark status of a building. Third, consideration should be given as to whether common-law trademark rights may exist in a building or any part of a building—that is, whether a building has become associated with a particular product or service.

3. Design Patents

Patent law grants broad protection to the patented item, but for a short period of time. The trade-off for those seeking this broad protection is that the patent holder must disclose how to create or reproduce the patented item. Design patents provide protection for 15 years from the date the design patent is issued. This differs from utility patents, which provide protection for 20 years from the date the associated patent application was filed. Design patents do not require maintenance fees. Given that a design patent may only be granted for a nonfunctional or ornamental element of a functional item, it may be invalidated if the design is determined to have practical utility. To be eligible for design patent protection, the design must be novel and nonobvious. Examples of design patents that have been granted to architectural items are the Statue of Liberty and the teepees of the Wigwam Motel. More recently, Apple was granted a design patent for the architectural design of its store on the Upper West Side of New York City.

Unlike a claim for copyright infringement, where access to the allegedly infringed work must be shown as part of a copyright infringement claim, a claim for patent infringement does not require proof of access or actual copying. Design patent infringement can occur even if the infringing design was a product of independent creation.

Additionally, design patent protection differs from trademark or trade dress in that there is no requirement that the patented item be used commercially. As a result, a design patent infringement claim does not require the establishment of consumer confusion or the likelihood of consumer confusion.

A design patent may protect an element of a building or some other structure on a piece of real property. The patent will have been granted to the inventor or inventors of the design. However, patent rights may

35. U.S. Patent D640,864 S.
be transferred, and as a result, the patent owner may be a person or business other than the inventor. In determining whether a design patent protects some element of a building or other structure, a search of the USPTO records should be conducted to see whether any patents have been granted. The date of the grant should also be identified to determine whether patent protection is still in effect. Additionally, the seller or lessor should be asked to make representations and warranties concerning the actual or potential design patents related to the building.

**B. Identifying IP Rights in Assets Incident to the Sale of a Building and Avoiding Infringement**

Established buildings do not come undorned, but typically include interior décor, artwork, and signage. When purchasing, selling, or leasing real estate, it is standard practice to identify the assets that will be incident to the sale or lease. When looking at things such as signs, billboards, awnings, and other items that serve as dressing or décor for the real property, the intangible IP rights tied to the physical asset should also be considered. Although the use of such items by incumbent tenants may present little difficulty, issues can arise when turnover occurs.

1. **Trademarks in a Building’s Signage and “Dressing”**

In addition to the overall look and feel of a building, discussed *supra*, the dressing of a building may contain separate protected marks in the form, for instance, of tenant signage or trade dress. Not only do items such as signs and billboards have importance in relation to potential future profits, advertising space, and corporate goodwill, they may also bear significant IP rights. Failing to clarify the future use of these items could result in a claim of trademark infringement or trademark dilution by the owner of the marks.

To avoid problems, steps should be taken to identify all signage and design elements (potentially including paint color) of a building and determine whether anyone other than the current owner of the building has rights in such items. Of course, to the extent the items belong to the current owner, they should be dealt with in any sale or lease documents. If ownership of the trademarks and service marks that are associated with a building are not transferred as part of a transfer or lease of the building, then care should be taken to determine what, if any, agreements exist concerning the use and maintenance of these marks.
To illustrate the foregoing, picture a familiar restaurant chain well-known for the bright red and white striped canopy attached to its restaurant facilities. If someone were to purchase a building with these features and operate a restaurant or other business without changing the look of the building, consumers may be confused and believe that the new restaurant or business is associated with the well-known restaurant. This could lead to a claim of trademark infringement by the owner of the well-known restaurant or, at the very least, unwanted preconceived notions about the new business.

2. Potential Claims for Trademark Infringement or Dilution

Generally, trademark infringement occurs when there is a likelihood of confusion between a protected mark and an allegedly infringing mark. A court will consider a variety of factors, including the strength of the protected mark, how similar the allegedly infringing use is to the protected trademark, and the proximity of use of the marks (i.e., whether the marks are used in the same markets and geographical areas). Trademark dilution occurs when a famous mark used in commerce is made less valuable or is disparaged by the use of an infringing mark.

As with copyrights, the highly fact-specific nature of trademark claims makes it difficult for a building owner or his or her attorney to accurately predict whether trademark infringement or dilution claims will apply. Again, the better practice is to inquire in advance of the sale or lease as to any trademark rights that exist in the property and the expectations of the buyer and the seller as to any changes that must occur in relation to the building’s appearance and signage.

3. Potential Claims for Use of Building’s Likeness or Placement of Signage

An additional area where the dressing of a building may interact with IP rights is in the context of the presentation of the building and associated materials in films and other media. For instance, in Sherwood 48 Associates, et al. v. Sony Corp. of America, the owners of various buildings sued a movie studio because advertising appearing on certain buildings portrayed in a movie had been modified to reflect the

advertising that promoted the movie studio, as opposed to displaying the actual appearance of the buildings. The court dismissed these claims because the plaintiffs failed to articulate the specific elements of the buildings’ trade dress that were affected by the changes made by the movie studio. Although this case brings no conclusive decision as to whether this type of action will succeed, it does support the idea that claims regarding harm to the overall appearance of a building or its trade dress could be brought.

Conversely, there may be opportunities for additional revenue or to protect assets related to the use of the image of a protected work or the placement of advertising on or near the building. In Gaylord v. United States, an artist was awarded a royalty for the use of the likeness of a sculpture on a U.S. postal stamp. In addition, in Minnesota Vikings Football Stadium, LLC v. Wells Fargo Bank, N.A., the owners of a professional football stadium obtained an injunction preventing a neighboring building from installing rooftop signage that violated a signage agreement. These claims are examples of rights that may impact revenue and require careful consideration to protect those assets when negotiating a real property agreement.

4. Naming Rights

Another area of potential disputes related to IP rights concerns naming rights in property, a building located on the property, or a portion of a building. Naming rights are essentially the right to attach a name to a piece of real property. These rights are usually sold for financial gain and used for branding purposes. They typically arise from contractual obligations that often flow with the property itself and may give rise to trademark issues as discussed previously (e.g., there may be obligations to change the signage if the owner of the naming rights changes its trademark or goes out of business). In addition, such rights are often

38. Sherwood 48, 76 F. App’x at 390.
39. Id.
41. Minnesota Vikings, 193 F. Supp. 3d at 1006–08.
coupled with other rights and obligations that may affect the value of a piece of property.43

Business attorneys may confront naming rights issues in three basic ways: (1) when representing a client who wants to sell naming rights; (2) when representing a client who wants to purchase naming rights; or (3) when representing a client who wants to purchase or lease a piece of property to which naming rights are already attached. Important considerations related to naming rights include the limitations on the type of name and duration of the attachment of the name to the property.

The property owner should consider what rights or benefits would be bestowed upon the person or organization that owns the naming rights. This may include determining whether the holder of the naming rights will have any interest in the actual property or, in the context of a lease, whether the tenant will be allowed to name the property.

In determining what rights to grant the owner of naming rights, the property owner should determine what impact the name will have on his or her business as owner of the property. Among other things, the property owner must consider the potential benefits and drawbacks of being associated with the name bestowed. The owner should also consider the cost, benefits, and duration of the rights sold and include any possible "outs" should unforeseen circumstances present themselves.

C. Identifying Rights in Art Incorporated as Part of the Building

The treatment of artwork installed in a building became an issue with the passing of VARA.44 This act is codified within the U.S. Copyright Act at 17 U.S.C. § 106A. Although this falls under copyright law, it defines rights that are in addition to and different from copyrights: so-called moral rights.

VARA was added to the copyright code to bring the United States into compliance with the Berne Convention for the Protection of Literary and Artistic Works, an international treaty dealing with the protection

of copyrighted works. As a signatory to the Berne Convention, the United States was required to provide a minimum level of protection for the moral rights of artists. Moral rights are rights granted to artists to protect their reputation and their work. Prior to the implementation of VARA, the United States had little to no protection for the moral rights of artists.

France is often credited as the greatest proponent of moral rights. The French conceptualization of moral rights includes:

- the right of attribution, consisting of the right to be identified or remain anonymous as the creator of a work and the right to prevent the creator's name from being credited to the creation of another work;
- the right of integrity, which is the right to protect the deformation, alteration, or destruction of a work so as to protect the reputation of the author;
- the right of disclosure, which includes the right of the author to determine when to reveal, withdraw, or modify his or her work to the public; and
- the right of withdrawal.

Moral rights under the Berne Convention and in the United States are limited to the rights of attribution and integrity. Moral rights differ from other copyrights because they are granted exclusively to the artist or creator of the protected work. They, generally, cannot be transferred and can be terminated only upon the death of the artist (or later) or waived in limited circumstances. Additionally, moral rights attach at the time a work is created.

The moral rights protected by VARA are limited to works of visual art. Works of visual art are defined as:

a painting, drawing, print, or sculpture, existing in a single copy, in a limited edition of 200 copies or fewer that are signed and consecutively numbered by the author, or, in the case of a sculpture, in multiple cast, carved, or fabricated sculptures of

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46. Id. at 112-13.
47. Id. at 108-09.
49. Id. § 106A.
200 or fewer that are consecutively numbered by the author and bear the signature or other identifying mark of the author; or a still photographic image produced for exhibition purposes only, existing in a single copy that is signed by the author, or in a limited edition of 200 copies or fewer that are signed and consecutively numbered by the author.50

VARA also defines items that are not considered to be works of visual art. These include publications such as books, maps, and newspapers; merchandising and advertising materials including product packaging; works made for hire; and other works that are not otherwise protected by copyright.51

Unless successfully claimed to be a sculpture, a building is not likely to qualify as a work of visual art for the purposes of VARA. However, VARA can have a significant impact on real property when a work of visual art is installed or attached to it. This also applies to temporary works in the context of works that are on buildings.52 Given that the visual artist retains the right to prevent the destruction, removal, or alteration of his work, a property owner may find that he is stuck with an unwanted piece of artwork.53

Although many pieces of art that are incorporated in or attached to a building may add tremendous value (e.g., consider the murals of Diego Rivera), some artwork may decrease the value of the property over time. It may also impede the ability of the owner or tenant to use the property in a manner that is conducive to his or her business purposes.

Section 113 of the Copyright Act details the steps that property owners must take to remove, destroy, or alter a visual work of art that is attached to or incorporated into a building or other piece of property.54 First, it must be determined whether a work is in fact a qualified work of

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50. Id. § 101.
51. Id.
52. Cohen, et al. v. G&M Realty, L.P., et al. (5Pointz Litig.), 15-CV-3230-FB-RLM, *23 (E.D.N.Y. 2018) (awarding $6,750,000 in damages to artists whose works of "exterior aerosol art[]" were destroyed when building owner whitewashed the buildings after the artists’ application for a preliminary injunction was denied, but before a trial to determine whether the art was protected under VARA).
54. See id. § 113(d)(1), (2).
visual art.\textsuperscript{55} Second, it must be ascertained whether the work is attached to or incorporated into the building or piece of property in such a way that it cannot be removed without alteration or destruction.\textsuperscript{56} Third, it is necessary to consider whether the visual artist waived his or her VARA rights. If not, then proper notice and opportunity must be given before any alteration or destruction of the work of art may occur. The failure to follow these steps can lead to a civil liability claim under VARA.\textsuperscript{57}

The implications of VARA create a situation where a building owner or tenant may want to take preventive measures to block the formation of VARA rights. In such case, a building owner should consider hiring the artist as an employee because works created by such employees will be "works for hire" that are unprotected by VARA.\textsuperscript{58} The other option is to require the artist to sign a waiver of his or her VARA rights. This strategy is necessary because once an artist qualifies for protection under the statute, his or her rights can be waived but not transferred. If a waiver of VARA rights is used, it must be in writing and signed by the artist, and it must explicitly state which art the waiver applies to, the person to whom the waiver is made, and that the artist expressly agrees to waive his or her VARA rights.\textsuperscript{59} A blanket waiver of "all rights" will not be sufficient to waive rights under VARA.

IV. Suggested Forms and Clauses for IP in Real Property Transactions

- In general, ensure that any document dealing with the sale or transfer of real property includes mention of any applicable IP

\textsuperscript{55} Courts will consider a variety of factors in determining what, if any, protection will extend to a particular work of visual art. The court will determine whether the work is of the type protected by the statute. This includes a determination of what constitutes the entirety of the work. For example, a large building may have a series of interrelated murals displayed on the walls throughout the whole of the building. In such case, the court must determine whether the murals as a whole constitute a work of visual art or if each individual mural constitutes a separate work. See Carter v. Helmley-Spear, Inc., 71 F.3d 77, 83–84 (2nd Cir. 1995).

\textsuperscript{56} Id.

\textsuperscript{57} 17 U.S.C. § 501 et seq.

\textsuperscript{58} See Carter, 71 F.3d at 83–84. The court will consider whether the work was made for hire. If the work is prepared by an employee in the scope of his or her employment, VARA protection is inapplicable. Id. at 85–89 (discussing what constitutes a work for hire). Additionally, some courts have suggested that they will weigh the protection afforded by VARA when it will have a severe negative impact on the alienability of the building or render the building wasteful. See 17 U.S.C. § 101.

\textsuperscript{59} 17 U.S.C. § 106A(e).
rights and what, if any, rights or payments are related thereto. Ensure that the IP rights are clearly identified and that any documentation necessary to transfer, waive, or terminate the applicable rights is completed.

- If applicable, include a naming rights agreement, for example, granting the naming rights to another party or restricting the right of a tenant to change the name of the leased property. Additionally, explicitly state what the ownership of naming rights includes and any profits or benefits to be granted to the purchaser of the naming rights. Duration of the rights and terms relating to how naming rights will be handled in the event the property is transferred in the future are also important considerations.

- Given that artists retain rights under VARA even after parting with copyrights, a property owner may want to establish additional protections against the formation of these rights. This may include requiring that all artwork installed on the property be created and installed by employees as works for hire, or requiring that all artists installing works sign a waiver of VARA rights. Waivers of VARA rights must be in writing, signed by the artist, specifically state the works for which the rights are being waived, and that the artist expressly agrees to the waiver. Blanket waivers will not be effective under the statute.

- Finally, proactive efforts to prevent the creation of IP rights in or attached to real property can help eliminate these concerns for future transactions involving the transfer of the real property. Conversely, if the creation of IP rights is intended or creates additional value in a property, the building owner should take steps to protect or enforce those rights.