Rejection of Intellectual Property License Agreements Under Section 365(n) of the Bankruptcy Code: Still Hazy After All These Years

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The economic woes of the past 18 months have dramatically increased the number and visibility of bankruptcy cases. With intellectual property assets comprising an increasing share of a company's value, debtors and companies planning for a potential bankruptcy filing need to understand the opportunities and pitfalls that bankruptcy presents to a debtor's intellectual property portfolio. When considering the possible rejection of intellectual property agreements, debtors must evaluate the special rights enjoyed by licensees of intellectual property rights, such as patents, trademarks, or trade secrets, under the Intellectual Property Bankruptcy Protection Act of 1988, codified in section 365(n) of the Bankruptcy Code. In the 20 years since its enactment, there have been surprisingly few published decisions applying this statutory provision to actual license agreements.

I. Executory Contracts and Section 365(n)

By way of background, the Bankruptcy Code permits a debtor to "reject" (breach and cease to perform) or "assume" (undertake and continue to perform) its executory contracts.[1] Executory contracts must be assumed or rejected in toto and may not be bifurcated into parts that will be rejected

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and those that will not.[2] Moreover, a court may require the debtor to assume or reject a license agreement together with all related agreements.[3]

Although "executory contract" is not a defined term under the Bankruptcy Code, a widely accepted definition of an executory contract is one "under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other."[4]

Courts consider intellectual property (IP) licenses to be executory contracts where there are ongoing, material obligations on both sides, such as the duty to indemnify, pay royalties, maintain confidentiality, provide updates, or adhere to quality standards.[5] A grant of exclusivity is another example of a key unperformed obligation on the licensor's part as it is comparable to an affirmative covenant on the licensor's part not to use or license the same IP during the term of the license.[6] Similarly, nonexclusive licenses have also been found to be executory due to ongoing mutual and material obligations. A license grant is viewed by certain courts as comparable to a continuing waiver of the licensor's right to sue the licensee for infringement for using the licensed IP, which in and of itself may be considered an ongoing and material obligation.[7] In a few cases, however, courts have found that where one party had fully performed its material duties under a particular IP license agreement, the license agreement was no longer executory.[8] For example, an author-licensor's contract with a debtor-licensee was held not to be executory because after the author granted the licensee distribution rights, the only remaining duties were the royalty payments due from the licensee.[9] In addition, a 2006 Delaware case suggested, in dicta, that a license that is expressly nonterminable may not be executory because performance is not excused regardless of a material breach of contract.[10]

Section 365(n) of the Bankruptcy Code provides a licensee of IP with special rights in the event that the debtor-licensor rejects an executory contract containing an IP license. Congress was motivated to adopt section 365(n) following a number of court decisions, most notably, the 1985 *Lubrizol* case decision in the Fourth Circuit.[11] In *Lubrizol*, the licensor of an unpatented metal coating technology unilaterally rejected its license agreements as executory contracts under section 365.[12] The debtor-licensor's actions were upheld under the "business judgment" standard that is normally applied when a debtor seeks to reject a contract or lease. The court noted that so long as the debtor-licensor's rejection was not in bad faith and was not a gross abuse of its business judgment, the court would uphold the debtor-licensor's business judgment and approve the rejection.[13]

The U.S. Department of Commerce, in a letter to the Senate Judiciary Committee, complained that the risk of IP licenses being rejected by debtor-licensors "exacerbate[s] the plight of independent inventors, small businesses and entrepreneurs in high risk areas."[14] In response to the "chilling effect" of the *Lubrizol* decision and others like it, Congress carved out a special exception to the general bankruptcy law governing the rejection of executory contracts applicable to IP licenses, which was manifested in 11 U.S.C.A. § 365(n).[15] The U.S. Senate Report relating to the bill that would become section 365(n) bemoaned the then-existing state of affairs as threatening "an end to the system of licensing of intellectual property… that has evolved over the many years to the mutual benefit of both the licensor and the licensee and to the country's indirect benefits."[16]

Section 365(n) essentially provides an IP licensee with a choice, following a debtor-licensor's rejection of a contract containing an IP license, to either: (i) treat the contract as terminated[17] or (ii) retain its rights under the contract to the subject IP (including any embodiment of such IP), as such rights existed immediately before the case commenced.[18] To the extent that the latter options is chosen, the licensee may retain these rights for the duration of such contract, including any period for which the contract may be extended by the licensee as of right.[19]

In retaining such rights, the licensee may enforce any exclusivity provision under the rejected contract but may not request specific performance of any other rights under the contract.[20] In addition, the licensee must continue to make all royalty payments due under the contract for the duration of the contract and waive any rights of setoff or claims for administrative expense with respect to such contract.[21]

For its part, the debtor[22] must provide to the licensee the licensed IP held by the trustee as it existed as of the petition date (including any such embodiment thereof) if so requested by the licensee and required under the contract or any agreement supplementary to such contract.[23] "Embodiments" of the licensed IP, according to the U.S. Senate Report, are tangible objects such as books, blueprints, or electronic media in which the intellectual property may be fixed or recorded.[24] The debtor may not interfere with the rights of the licensee to such IP, as provided in the contract or any agreement supplementary thereto, including any right to obtain the IP from a third party.[25]

II. The Application of Section 365(n)

Despite what appears to be a comprehensive statutory scheme, a number of issues emerge in practice when applying section 365(n) to license agreements. There are questions as to the types of IP licenses that are within its scope, what IP continues to be available to the licensee after rejection of the license, what a "supplemental agreement" is, what services the licensee may continue to receive from the licensor, and what obligations the licensee must continue to perform post-rejection. Only a handful of published decisions have addressed these questions and the answers are still not clear.

1. What "Intellectual Property" Licenses Are Within the Scope of 365(n)?

Only a licensee of "intellectual property" may exercise rights under section 365(n). The term "intellectual property" is defined in the Bankruptcy Code to mean the following: (a) trade secret; (b) invention, process, design, or plant protected under Title 35 (the U.S. Patent Act); (c) patent application; (d) plant variety; (e) work of authorship protected under Title 17 (the U.S. Copyright Act); or (f) mask work protected under Chapter 9 of Title 17 (the U.S. Copyright Act); to the extent protected by applicable nonbankruptcy law.[26]

A. Trademarks

Noticeably absent from the definition of "intellectual property" are "trademarks," which the legislative history indicates were deliberately excluded by Congress in enacting section 365(n).[27] According to the U.S. Senate Report, the definition of "intellectual property" was meant to cover "virtually all types of rights (other than trademarks or similar rights) whether protected by federal or state law statutory or common law."[28] The rationale for excluding trademarks from section 365(n) is that including them would conflict with Congress's vision of a passive postrejection role for the debtor: a trademark licensor has an ongoing duty to safeguard the quality of the trademarked products in order to preserve the enforceability of its marks, whereas Congress wanted to avoid saddling a debtor with ongoing obligations.[29] Various courts have relied on the legislative history in refusing to apply section 365(n) to trademarks.[30] Consistent with this, rejected trademark licenses may not be continued by licensees under section 365(n) although one court, in the context of a rejected license that covered both trademarks and trade secrets relating to a single product line, suggested that the licensee might continue the entire license, including the trademark, notwithstanding the rejection.[31] In that case, the court suggested that it would permit the licensee to continue to use a secret formula for rum as well as the rum label (which appeared to also have elements of copyrighted designs), were the rejection approved.[32] This decision, however, has attracted criticism.[33] A later court, analyzing a rejected license agreement which granted both a copyright (software) and trademark license, bifurcated the agreement, allowing the licensee to continue to copy and distribute the copyrighted software but requiring the licensee to remove the licensed marks from the packaging.[34]

Because courts may extend the protections of section 365(n) to a nondebtor licensee's use of a trademark in certain mixed license agreements, companies engaged in planning for a bankruptcy filing should consider executing separate contracts for forms of intellectual property protected under section 365(n) and forms of intellectual property not covered by section 365(n). As discussed in more detail below, this structure reduces the risk that a bankruptcy court would find a trademark protected by section 365(n), thus leading a court to bifurcate the trademark from the other licenses. In the case of an exclusive license, bifurcation effectively allows the debtor-licensor to recommence use of its licensed mark. In the case of a nonexclusive mark, terminating the licensee's use of the trademark may increase the value of that intellectual property to the debtor's estate.

The effect of rejecting of a trademark license is that the license is deemed terminated, the licensor can resume its use of the licensed mark (if the license was exclusive), and under section 365(g) of the Bankruptcy Code, the licensee has a prepetition general unsecured claim against the licensor for damages resulting from the rejection and the consequent loss of the license.[35] Without the benefit of the license, the licensee must cease using the licensed mark but may be entitled to a transition period to mitigate its damages claim and the disruption of its business. One court allowed for a 30-day transition period to phase out a franchisee's use of a proprietary mark.[36] Another court allowed for a two-year period, although the licensee requested five years, because the terminated license agreement allowed for a "reasonable period not to exceed two years" to discontinue use of the mark in the event that the license was terminated.[37]

B. Non-U.S. IP

In addition to the lack of clarity with respect to marks, another area of haziness is whether 365(n) applies to non-U.S. IP. The definition of "intellectual property" applicable to section 365(n) appears to be limited to IP that is patented or copyrighted in the U.S. Section 101(35A) of the Bankruptcy Code, which defines intellectual property for purposes of 365(n), covers inventions, copyrights, and mask works expressly defined by reference to the applicable U.S. Code Title under which they are protected. Yet trade secrets, plant varieties, and patent applications appear to be unrestricted as to territory. There is a certain lack of logic to this scheme, especially as it concerns patent applications which are unrestricted as to territory. When non-U.S. patent applications mature into patents, are they automatically outside the scope of 365(n)?

The legislative history does not provide insight into the U.S. vs. non-U.S. IP debate. Various commentators argue that licenses of non-U.S. IP should be covered. For example, the noted copyright treatise, Nimmer on Copyrights, observes that, despite the statutory reference to Title 17, worldwide copyrights should be considered as "intellectual property" for purposes of the Bankruptcy Code, if the copyrighted work is also protected under U.S. copyright law.[38] One court has applied section 365(n) to protect a license of copyrighted software in Canada, without analysis of the issue.[39] With respect to patents, some commentators suggest that non-U.S. patents should be included in the definition of "intellectual property" on policy grounds while others disagree based on the literal wording of the statute.[40]

The exclusion of trademarks and the possible exclusion of non-U.S. IP from the definition of "intellectual property" under the Bankruptcy Code creates uncertainty as to how section 365(n) would apply to agreements that license a combination of IP. As noted above, there are a couple of reported cases addressing licenses covering trademarks and other IP but none addressing the treatment under section 365(n) of IP licenses that combine U.S. and non-U.S. IP.

2. Improvements to IP

Section 365(n) provides that, in the event of a rejection, the licensee may elect to retain its rights to the IP "as such rights existed immediately before the case commenced."[41] To identify what rights licensees may retain under section 365(n), debtors seeking to reject IP contracts must first establish when the case commenced for purposes of section 365(n). In the context of a Chapter 11 case, the answer is elementary—the case commences on the date that the petition for relief is filed.[42] But what happens in the circumstance where a Chapter 11 cases converts to a Chapter 7 case? In other words, can the licensee argue that, for purposes of section 365(n), the case "commenced" following the conversion to Chapter 7?

Section 348(a) of the Bankruptcy Code provides that while conversion of a case from one chapter to another is equivalent to an order for relief under the chapter to which the case is converted, it does not affect the date of the filing of the petition, the commencement of the case, or the order for relief, except as expressly provided in 348(b) and (c).[43] Thus, unless otherwise provided, "[u]nder section 348(a), conversion leaves [the date of commencement] unchanged; accordingly, all provisions of the Code that are keyed to that date are also unaffected by conversion."[44] Section 365(n) is not listed as one of the exceptions where the conversion date serves as the new petition date. In fact, one case applied section 348(a) of the Bankruptcy Code to section 365(n) and confirmed that the "commencement date" under section 365(n) does not change upon conversion to a Chapter 7 case.[45]

An important consideration in interpreting section 365(n) is to determine what IP rights the licensee may retain after rejection of the licensed agreement by the licensor. The statute provides that the licensee may retain its rights in licensed IP "as such rights existed immediately before the case commenced."[46] The scope of these rights that exist at the time of the petition date may be limited either by the terms of the contract or by the state of the licensed IP itself. Notwithstanding the seemingly plain language of the statute, however, some courts and leading commentators have argued that licensees should be entitled to retain their rights to the form of the licensed IP as of the date that the debtor rejects the contract as opposed to the date the case is commenced.

In *In re Storm Technologies*, in evaluating a contract that provided the licensee with a nonexclusive license upon the occurrence of a condition precedent that had not occurred as of the petition date, the court held that section 365(n) did not preserve a license grant at all because the claimed license was not in effect on the petition date and the licensee possessed only contingent rights to the license as of the commencement of the case.[47] The court noted that upon the filing of a bankruptcy petition, the rights of the parties become fixed, "subject to the rights and remedies incorporated in the Bankruptcy Code."[48] Moreover, the court rejected an argument that the legislative history revealed an intent to include licenses whose term had not commenced as of the petition date within the scope of section 365(n), reasoning that the plain meaning of the statute only protected those rights that existed immediately before the case commenced.[49]

In evaluating situations where the licensee clearly had some rights to the IP as of the petition date, other courts have taken the "state of the IP" approach and held that upon the licensee's exercise of its rights under section 365(n), it would be entitled to use the license in the state in which the intellectual property existed as of the filing of the petition. In other words, improvements to the IP made by the licensor after the filing of the petition would not be available to the licensee.[50] This perspective is consistent with the approach set forth in *In re Storm Technology*.[51] Moreover, this interpretation is arguably also consistent with section 365(g)(1), which provides that the rejection of an executory contract "constitutes a breach of such contract… immediately before the date of the filing of the petition."[52]

A licensee may be able to argue that the date of rejection, rather than the date of commencement of the case, should be the benchmark for the state of the IP, thereby requiring the debtor to provide access to any improvements between the commencement and the case and the rejection of the contract. One court, in the context of a software upgrade, held that the licensee would be barred from seeking postrejection, as opposed to prerejection, upgrades.[53] To be clear, the court allowed the licensee to retain any postpetition, prerejection improvements to the licensed software. Allowing the licensee to use improvements to the IP that occurred postpetition but before the license was rejected is also arguably supported by the legislative history of section 365(n), which states that the section is intended "to make clear that the rights of an intellectual property licensee to use the licensed property cannot be unilaterally cut off as a result of the rejection of the license."[54] In addition, a licensee could argue that it is being treated inequitably since it must continue paying full royalties under the contract, with no right of setoff or claims for administrative expenses,[55] even if that contract would have otherwise provided IP updates to the licensee.

Cutting off IP improvements made after rejection rather than the petition date, although arguably inconsistent with the statutory language pegged to the "commencement of the case," is frequently a more practical approach because it may be difficult to retroactively remove the licensed IP from a product line that was created in between the commencement of the case and the rejection. In any event, debtor-licensors should be aware of possible disputes as to what improvements are owed to a licensee if it elects to continue to receive IP under section 365(n).

3. Licensor's Services

Section 365(n) states that if the trustee rejects the IP license agreement, affirmative obligations on the licensor's part will not continue. Specifically, section 365(n)(1)(B) provides that a licensee may retain its rights to use the licensed IP, including on an exclusive basis if the license is exclusive, but does not retain any rights to specific performance of any other rights under the contract.

This has been interpreted by courts to preclude the licensee's continued receipt of services from the licensor.[56] The only obligations to which the licensor may be held are providing access to the licensed IP including "embodiments" thereof, abiding by any nondisclosure agreements and, in circumstances where the license is an exclusive license, refraining from licensing the covered IP to others.[57] Thus where a license agreement includes services, such as engineering support, training, and testing, the debtor-licensor's obligation to provide such services will not survive its rejection of the license.

4. Supplementary Agreements

Section 365(n) expressly applies not only to IP license agreements but also to agreements "supplementary" thereto. Specifically the statute provides that the IP licensee may elect to "retain its rights… under such contract and under any agreement supplementary to such contract, to such intellectual property (including any embodiment of such intellectual property to the extent protected by applicable nonbankruptcy law), as such rights existed immediately before the case commenced."[58]

Accordingly, the licensee is entitled, upon request, to obtain from the licensor's bankruptcy trustee, to the extent provided in such contract or any agreement supplementary to such contract, any intellectual property (including such embodiment) held by the trustee.[59] Moreover, the trustee shall "not interfere with the rights of the licensee as provided in such contract, or any agreement supplementary to such contract, to such intellectual property (including such embodiment) including any right to obtain such intellectual property (or such embodiment) from another entity."[60] As mentioned above and applicable here to section 365(n)(3), a debtor-in-possession in a Chapter 11 case is treated as the "trustee" if there is no case trustee appointed.[61]

The Senate Report notes that "It is… not unusual for the license agreement to be one of several agreements governing the working relationship between the licensor and licensee."[62] According to the Senate Report, an escrow agreement, for example, would be considered an agreement "supplementary" to the IP license agreement.[63] Escrows are often set up in connection with software licenses so that a third party holds the source code, to be delivered to the licensee upon rejection of the license. Depending what documents are considered supplementary agreements, these provisions in section 365(n) might force a debtor to continue to provide services in connection with the licensed IP to the extent that they are contained in a separate agreement.

We have found no cases where a licensee has raised this argument. On the one hand, the enforcement of services obligations contained in supplementary agreements seems to make an end run around the prohibitions against the specific performance of similar obligations contained in a license agreement and would, therefore, be objectionable as a policy matter. On the other hand, a literal reading of section 365(n) leaves the door open for such an argument because the exclusion of specific performance appears only to apply to the license contract and not to supplemental agreements.[64]

5. Payment of Royalties

If the licensee elects to retain its rights to use the IP after the debtor has rejected the executory contract, section 365(n) of the Bankruptcy Code requires that the licensee continue to pay the "royalty" for the duration of the contract. Courts have broadly interpreted the term "royalties" to include any payment for use of the IP, regardless of nomenclature and regardless of whether based on a flat fee or on a percentage of sales.[65] Accordingly, a licensee may be required to make the same payments under the rejected license agreement, even though the licensee may be receiving fewer services and benefits going forward.[66] In *Centura Software*, which involved a license for both a copyrighted software program and its related trademark name, the licensee elected to continue selling the licensed software under section 365(n) after the debtor rejected the agreement; however, the licensee was not permitted to continue use of the trademark.[67] Whatever damages the licensee would suffer from continuing to pay royalties under the licensing agreement without the trademark could only be recovered through a general unsecured claim for breach of the agreement under section 365(g) rather than through a deduction to the royalties due under the original agreement.[68]

If a licensee elects to retain the IP after a debtor rejects a license agreement, and the licensee is not allowed to use postpetition, prerejection improvements to the licensor's IP following such rejection as suggested by the plain language of section 365(n), then what recourse does the licensee have for its damages? Clearly the licensee may assert a general unsecured claim.[69] However, as reflected in the fact pattern set forth in *Centura Software*, that may leave a licensee wanting. In other situations, a creditor is generally entitled to the right of setoff, either by statute or contract.[70] However, if the licensee elects to retain its rights, section 365(n) requires the waiver of setoff rights and any claims for administrative expenses allowable under section 503(b) relating to the performance of the license.[71] Thus under the statutory language, the lessee seems to be limited in remedy to the assertion of an unsecured prepetition claim under sections 365(g) and 502(g).

An interesting question is whether section 365(n) also eliminates a licensee's right to recoupment.[72] Based on the literal reading of the statute, it is arguable that section 365(n) is silent as to recoupment rights, thereby permitting recoupment. A licensee who seeks to reduce its royalty payments to the debtor based on their damages resulting from the lack of access to postpetition, prerejection improvements to IP may argue that such an offset is not barred by section 365(n) since setoff and recoupment can be treated differently in the bankruptcy context, and section 365(n) does not specifically prohibit recoupment.[73] Indeed, several cases indicate that setoff is distinct from recoupment and that recoupment does not require mutuality of obligations.[74] Thus debtors should be aware that a licensee may try and argue that Congress's specific choice of words requiring a licensee to waive "setoff" still permits the licensee to effectuate recoupment to offset royalties owed under the licensee by the value of any damage caused by the debtor's nonperformance (including damages arising from the lost use of postpetition improvements to the IP) after the date of rejection.

Whether a licensee could successfully utilize the recoupment doctrine to reduce their royalty payments based on damages suffered by postpetition, prerejection improvements to IP is unclear. Although setoff and recoupment have technical differences and different origins in the common law, the right of setoff is often used in a broader context to refer to all payment offsets of any kind, including recoupment.[75] Accordingly, Congress may have intended to use the term "setoff" in a more general sense when requiring that licensees waive such rights pursuant to section 365(n).

Moreover, a debtor-licensor could challenge an attempt by a licensee to reduce its royalties under a recoupment theory by arguing the exact opposite case, i.e., if Congress had intended to permit a licensee to avail itself of recoupment, it could have done so explicitly as it did, for example, in sections 365(h) and (i).[76] A debtor could also point to the tendency for courts to use the terms "setoff" and "recoupment" interchangeably to make the point that Congress in fact was not making any distinction between the two doctrines, and accordingly, by barring setoff, recoupment is likewise prohibited.[77] Moreover, distinct from section 365(n), the construct of sections 365(h) and (i) does not permit the affected creditor to assert any right or claims (other than the right of offset) against the debtor on account of any damage occurring after the date of rejection caused by the debtor's nonperformance.[78] This makes sense where the creditor's remedy is limited to recoupment because recoupment is "essentially a defense to the debtor's claim against the creditor rather than a mutual obligation"—for example where a lessee is permitted to reduce rental payments owed to a debtor by the value of any damage caused by the debtor's nonperformance—and is strictly for the purpose of reducing the debtor's claim against the creditor and does not give rise to affirmative claims.[79] In other words, the language used by Congress in section 365(n) may in fact be a purposeful decision to limit the remedy available to a licensee under 365(n) to the assertion of a general unsecured claim, distinct from the different remedies available under other various subsections.

6. Licensee's Obligations

Section 365(n) of the Bankruptcy Code does not expressly address what obligations the licensee must continue to perform under the rejected license agreement, other than the obligation to continue making royalty payments. In *Quad Systems*, the court gave guidance, in dicta and without giving examples, stating that the licensee remains bound by the obligations or duties required to be performed by it under the rejected license, "except for those so directly related to the obligations or duties that the licensor has been freed from by rejection, as to make it inequitable to bind the licensee to them."[80] Ironically, this statement seems to contradict the holding of *Centura Software*, which, as discussed above, required a licensee to pay all royalties under a contract, even where the licensee lost access entirely to the trademark rights under such contract after making the section 365(n) election.[81] Because *Quad Systems* is an unpublished opinion, one should be wary of its persuasiveness.

III. Conclusion

In conclusion, the legislative history and case law interpreting section 365(n) provide some guidance to interpreting the grey areas in the statute itself:

- Trademark rights are not covered by section 365(n), and therefore, the licensee would not likely be able to continue using any licensed trademarks.
- Based on the plain language of the Bankruptcy Code, it is possible that section 365(n) covers only the rights to use U.S. copyrights, U.S. patents, and U.S. mask works (but all trade secrets), although this result has been criticized as illogical, and alternative interpretations have been proposed by commentators.
- The licensee may not be entitled to any of the licensor's post-petition improvements in the licensed IP, even if the agreement contemplates that future improvements are included.
- The licensee will not be entitled to receive any services such as engineering support, training, and product testing from the licensor under the continued license agreement, but there is some

ambiguity as to the status of these services when contained in a supplementary agreement.

- The licensee likely will have to pay the full royalty due under the license agreement to the extent that it was not expressly allocated among the various types of IP, or between IP and services, but the licensee may argue that they are entitled to recoup any damages arising from the loss of access to postpetition IP.
- The licensee will likely have to observe all its other obligations under the license agreement, except, possibly, duties that are so directly related to the licensor's excused obligations that continuance would be inequitable.

Nevertheless, because there are still so few opinions interpreting section 365(n), there is room for alternative developments. As more cases apply section 365(n) to actual license rejections, clarity will hopefully emerge from the haze.

NOTES

1. 11 U.S.C.A. § 365.

2. If a debtor elects to assume an executory contract or unexpired lease, it is well settled that it must assume the contract or lease in its entirety. See, e.g., N.L.R.B. v. Bildisco and Bildisco, 465 U.S. 513, 531, 104 S. Ct. 1188, 79 L. Ed. 2d 482, 11 Bankr. Ct. Dec. (CRR) 564, 9 Collier Bankr. Cas. 2d (MB) 1219, 5 Employee Benefits Cas. (BNA) 1015, 115 L.R.R.M. (BNA) 2805, Bankr. L. Rep. (CCH) P 69580, 100 Lab. Cas. (CCH) P 10771 (1984); In re Fleming Companies, Inc., 499 F.3d 300, 308, 48 Bankr. Ct. Dec. (CRR) 188, Bankr. L. Rep. (CCH) P 80996 (3d Cir. 2007); In re Allegheny Health Educ. and Research Foundation, 383 F.3d 169, 177-78, 43 Bankr. Ct. Dec. (CRR) 174, 175 L.R.R.M. (BNA) 2840, Bankr. L. Rep. (CCH) P 80169, 150 Lab. Cas. (CCH) P 10393 (3d Cir. 2004); Stewart Title Guar. Co. v. Old Republic Nat. Title Ins. Co., 83 F.3d 735, 741, 29 Bankr. Ct. Dec. (CRR) 184 (5th Cir. 1996); City of Covington v. Covington Landing Ltd. Partnership, 71 F.3d 1221, 1226, 28 Bankr. Ct. Dec. (CRR) 377, 34 Collier Bankr. Cas. 2d (MB) 822, Bankr. L. Rep. (CCH) P 76734, 1995 FED App. 0376P (6th Cir. 1995); Matter of Chicago, Rock Island and Pacific R. Co., 860 F.2d 267, 272 (7th Cir. 1988); In re Exide Technologies, 340 B.R. 222, 228-29, 46 Bankr. Ct. Dec. (CRR) 95 (Bankr. D. Del. 2006), appeal denied, judgment aff'd, 2008 WL 522516 (D. Del. 2008); In re Atlantic Computer Systems, Inc., 173 B.R. 844, 849 (S.D. N.Y. 1994); In re Leslie Fay Companies, Inc., 166 B.R. 802, 808, 25 Bankr. Ct. Dec. (CRR) 870, Bankr. L. Rep. (CCH) P 75908 (Bankr. S.D. N.Y. 1994).

3. See Exide, 340 B.R. at 228-29 (holding that asset purchase agreement, trademark license agreement, and administrative services agreement constituted one integrated agreement that had to be assumed or rejected in its entirety).

4. Vern Countryman, Executory Contracts in Bankruptcy: Part I, 57 Minn. L. Rev. 439, 460 n.85 (1973).

5. See In re Buildnet Inc., No. 01-82293 (Bankr. M.D.N.C. Sept. 20, 2002); see also In re Golden Books Family Entertainment, Inc., 269 B.R. 311, 314 (Bankr. D. Del. 2001) (noting that courts generally find intellectual property licenses to be "executory" under the Countryman definition); Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043, 12 Bankr. Ct. Dec. (CRR) 1281, 12 Collier Bankr. Cas. 2d (MB) 310, 226 U.S.P.Q. 961, Bankr. L. Rep. (CCH) P 70311 (4th Cir. 1985); Exide, 340 B.R. at 239 (quoting In re Novon Intern., Inc., 2000 WL 432848, at *4 (W.D. N.Y. 2000)("Generally speaking, a license agreement is an

executory contract as such is contemplated in the Bankruptcy Code" (internal quotation marks and punctuation omitted)).

6. Marcelo Halpern, 950 Prac. L. Inst.: Patents 611, 625, Bankruptcy Issues in Intellectual Property Licensing (2008).

7. In re HQ Global Holdings, Inc., 290 B.R. 507, 511, 40 Bankr. Ct. Dec. (CRR) 262 (Bankr. D. Del. 2003) (citing In re CFLC, Inc., 89 F.3d 673, 677, 29 Bankr. Ct. Dec. (CRR) 520, 36 Collier Bankr. Cas. 2d (MB) 297, 39 U.S.P.Q.2d 1518 (9th Cir. 1996) ("a [nonexclusive] patent license constitutes an executory contract because a license is, 'in essence, a mere waiver of the right to sue the licensee for infringement.'")).

8. In re Gencor Industries, Inc., 298 B.R. 902, 913 (Bankr. M.D. Fla. 2003) (settlement agreement and related irrevocable license not executory contracts because no material obligations remained for the parties to perform); In re Qintex Entertainment, Inc., 950 F.2d 1492, 1495-96, 26 Collier Bankr. Cas. 2d (MB) 143, 21 U.S.P.Q.2d 1775, Bankr. L. Rep. (CCH) P 74396 (9th Cir. 1991).

9. Qintex, 950 F.2d at 1495-96.

10. Exide, 340 B.R. at 230-31 (noting nondebtor's argument that if party cannot terminate the contract upon a material breach, a necessary element under the Countryman test, the contract cannot be executory).

11. Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043, 12 Bankr. Ct. Dec. (CRR) 1281, 12 Collier Bankr. Cas. 2d (MB) 310, 226 U.S.P.Q. 961, Bankr. L. Rep. (CCH) P 70311 (4th Cir. 1985).

12. Lubrizol, 756 F.2d at 1047.

13. Lubrizol, 756 F.2d at 1047.

14. See 4-19A Melville B. Nimmer and David Nimmer, Nimmer on Copyright § 19A.06[B] (rev. ed. 2009) (citing S. Rep. No. 100-505 (1988), reprinted in 1988 U.S.C.C.A.N. 3200, 3202).

15. 4-19A Nimmer on Copyright at §19A.06[B][1].

16. S. Rep. No. 100-505, at 3.

17. 11 U.S.C.A. § 365(n)(1)(A). With respect to a licensee's termination right, the statute specifically states that "the licensee under such contract may elect—(A) to treat such contract as terminated by such rejection if such rejection by the trustee amounts to such a breach as would entitle the licensee to treat such contract as terminated by virtue of its own terms, applicable nonbankruptcy law, or an agreement made by the licensee with another entity." 11 U.S.C.A. § 365(n)(1)(A). As discussed above, an argument can be made that licenses that are expressly nonterminable are not executory and accordingly not within the scope of section 365 of the Bankruptcy Code. See Exide, 340 B.R. at 230-31 for an interesting discussion of this issue in the context of whether a nonterminable license is executory. Licensors should be aware of the risks in granting nonterminable licenses because, in the bankruptcy context, it may not be able to reject these agreements if the bankruptcy court finds such agreements to be nonexecutory.

18. 11 U.S.C.A. § 365(n)(1)(B).

19. 11 U.S.C.A. § 365(n)(1)(B).

20. 11 U.S.C.A. § 365(n)(1)(B).

21. 11 U.S.C.A. § 365(n)(2)(C).

22. Pursuant to 11 U.S.C.A. § 1107(a), "a debtor in possession shall have all the rights… of a trustee serving in a case under [Chapter 11]." Accordingly, the term "trustee," as used in section 365(n), includes a debtor in possession.

23. 11 U.S.C.A. § 365(n)(3)(A).

24. S. Rep. No. 100-505, at 7.

25. 11 U.S.C.A. § 365(n)(3)(B).

26. 11 U.S.C.A. § 101(35A).

27. S. Rep. No. 100-505, at 5.

28. S. Rep. No. 100-505, at 7.

29. See H.R. Rep. No. 1012, 100th Cong., 2d Sess. (1988) ("The debtor/trustee will essentially have no obligation to the licensee after rejection other than to turn over existing technology and permit the licensee to use the technology").

30. Exide, 340 B.R. at 249-50; In re Centura Software Corp., 281 B.R. 660, 670-71, 39 Bankr. Ct. Dec. (CRR) 249 (Bankr. N.D. Cal. 2002). See also HQ Global Holdings, 290 B.R. at 513 n.5.

31. In re Matusalem, 158 B.R. 514, 521-22, 29 U.S.P.Q.2d 1519, Bankr. L. Rep. (CCH) P 75480 (Bankr. S.D. Fla. 1993).

32. Matusalem, 158 B.R. at 521-22 (noting that if trademark license is critical to use of other IP, the trademark may fall under section 365(n)).

33. See Centura Software, 281 B.R. at 671-73 ("*Matusalem*'s dicta does not suggest an extension of § 365(n) protection to trademarks upon a balancing of equities" and noting that "because alternative grounds existed for its holding, the court disagrees that the *Matusalem* court denied the rejection on the basis of § 365(n)'s legislative history"). See also Stuart M. Riback, Intellectual Property Licenses: The Impact of Bankruptcy, 950 Prac. L. Inst.: Patents 647, 663 (2008) ("To date, [the *Matusalem*] case has had very limited influence. Because of its unusual facts and the alternative bases[sic] for its decision, *Matusalem* may well never be widely accepted."); Norton Bankruptcy Law and Practice 3d § 121:19 n.2 ("So while *Matusalem* is interesting reading, it has limited precedential value").

34. Centura Software, 281 B.R. at 672-73.

35. Exide, 340 B.R. at 250.

36. HQ Global Holdings, 290 B.R. at 514.

37. Exide, 340 B.R. at 251.

38. See 4-19A Nimmer on Copyright § 19A.06[c][1]; see also Marcelo Halpern, 950 Prac. L. Inst: Patents 611, Bankruptcy Issues in Intellectual Property Licensing (2008).

39. In re EI Intern., 123 B.R. 64, 65, 18 U.S.P.Q.2d 2045 (Bankr. D. Idaho 1991) (software license for use in Canada allowed to continue by virtue of 365(n)).

40. Compare Michael A. Epstein and Frank L. Politano, Drafting License Agreements § 6.02[C][1] (4th ed. 2002) ("There is no plausible policy reason for excluding foreign patents"); with James S. Hilboldt, Jr., Key License Clauses, 334 Prac. L. inst. 191, 209 (1992) ("There is no clear statutory assurance that [365(n)] protects the [patent] licensee outside the United States. (It is generally believed that the provision does allow the licensor to retain its rights outside the United States to technical information; whether the licensee has a comparable right to retain its patent rights is less clear)"); and Diane Savage, Selected Issues in Structuring Direct Alliances 1063 Prac. L. Inst.: Corp. 167, 183 (1998) ("Although the ["intellectual property"] definition is relatively broad,… it appears that issued foreign patents are [] not included").

41. 11 U.S.C.A. § 365(n)(1)(B).

42. 11 U.S.C.A. § 301(a).

43. 11 U.S.C.A. § 348(c). Section 348(c) provides that "[s]ections 342 and 365(d) of this title apply in a case that has been converted… as if the conversion order were the order for relief."

44. See In re Bell, 225 F.3d 203, 211, 36 Bankr. Ct. Dec. (CRR) 215, 44 Collier Bankr. Cas. 2d (MB) 1576, Bankr. L. Rep. (CCH) P 78279 (2d Cir. 2000); see also In re Szombathy, 1996 WL 417121, at *11 n.5 (Bankr. N.D. Ill. 1996), rev'd in part, 1997 WL 189314 (N.D. Ill. 1997) ("Section 348(a) provides that, except as otherwise provided, conversion does not effect a change in the date of the filing of the petition, the commencement of the case, or the order for relief. Section 365(n) is not one of the exceptions."), rev'd on other grounds by sub nom. Szombathy v. Controlled Shredders, Inc., 1997 WL 189314, at *1 (N.D. Ill. 1997) (noting that debtor did not dispute bankruptcy court's finding that licensee was not entitled to any modifications or improvements after the initial commencement date of the Chapter 13 case on August 4, 1994).

45. Szombathy, 1996 WL 417121 at *11 n.5.

46. 11 U.S.C.A. § 365(n)(1)(B).

47. In re Storm Technology, Inc., 260 B.R. 15, 1542, 45 Collier Bankr. Cas. 2d (MB) 1652 (Bankr. N.D. Cal. 2001). Though improvements to IP were not at issue in the case, the court's conclusion that the rights of the licensee were "fixed" as they existed at the petition date may have application to postpetition improvements to IP. See Storm Technology, 260 B.R. at 157.

48. Storm Technology, 260 B.R. at 157.

49. Storm Technology, 260 B.R. at 157; see also U.S. v. Gonzales, 520 U.S. 1, 7-8, 117 S. Ct. 1032, 137 L. Ed. 2d 132 (1997) (holding that "the text, rather than the legislative history," controlled a statute's interpretation when the statute was clear on its face).

50. Szombathy v. Controlled Shredders, 1997 WL 189314 at *3 see also In re Quad Systems Corp., 2001 WL 1843379, at *14 (E.D. Pa. 2001) ("the licensee will have the right to use the technology only in the form that existed as of the filing date").

51. Storm Technology, 260 B.R. at 157.

52. 11 U.S.C.A. 365(g)(1).

53. Centura Software, 281 B.R.at 669; see also Norton Bankruptcy Law and Practice 3d § 177:37 ("[t]hus, the right of the nondebtor's licensee to elect to retain its rights under the license is limited to the state of the technology as it existed at the time of rejection by the debtor").

54. S. Rep. No. 100-505, 100th Cong., 2d Sess. 5 (1988), reprinted in 1988 U.S.C.C.A.N. 3200, 3207.

55. 11 U.S.C.A. § 365(n)(2).

56. Quad Systems, 2001 WL 1843379 at *13 (citing H.R.Rep. No. 1012, 100th Cong., 2d Sess. (1988) ("Obligations such as that to provide the licensee with continued training in the use of the technology or with updates of the technology will be terminated by rejection")).

57. Szombathy, 1996 WL 417121 at *11; 4-19A Nimmer on Copyright § 19A.06; see also Quad Systems, 2001 WL 1843379 at *13 (citing H.R. Rep. No. 1012, 100th Cong., 2d Sess. (1988)) ("The debtor/trustee will essentially have no obligation to the licensee after rejection other than to turn over existing technology and permit the licensee to use the technology")).

58. 11 U.S.C.A. § 365(n)(1)(B).

59. 11 U.S.C.A. § 365(n)(1)(B).

60. 11 U.S.C.A. § 365(n)(3)(B).

61. 11 U.S.C.A. §§ 1101(1), 1107(a).

62. S. Rep. No. 100-505, at 9 (1988).

63. S. Rep. No. 100-505, at 9 (1988).

64. 11 U.S.C.A. § 365(n)(1)(B) reads:

> If the trustee rejects an executory contract under which the debtor is a licensor of a right to intellectual property, the licensee under such contract may elect…
>
> > (B) to retain its rights (including a right to enforce any exclusivity provision of such contract, but excluding any other right under applicable nonbankruptcy law to specific performance of such contract) under such contract and under any agreement supplementary to such contract, to such intellectual property (including any embodiment of such intellectual property to the extent protected by applicable nonbankruptcy law), as such rights existed immediately before the case commenced.

65. In re Prize Frize, Inc., 32 F.3d 42, 4296, 25 Bankr. Ct. Dec. (CRR) 1615, 31 Collier Bankr. Cas. 2d (MB) 1422, 31 U.S.P.Q.2d 1861, Bankr. L. Rep. (CCH) P 76039 (9th Cir. 1994) (payments termed "license fees" under license agreement considered "royalties" for purposes of section 365(n)).

66. Norton Bankruptcy Law and Practice 3d § 177:37. See, e.g., Centura Software, 281 B.R. at 669.

67. Centura Software, 281 B.R. at 669.

68. Centura Software, 281 B.R. at 673-74.

69. 11 U.S.C.A. §§ 365(g), 502(g)(1).

70. 11 U.S.C.A. § 553(a); see Citizens Bank of Maryland v. Strumpf, 516 U.S. 16, 18, 116 S. Ct. 286, 133 L. Ed. 2d 258, 28 Bankr. Ct. Dec. (CRR) 97, 33 Collier Bankr. Cas. 2d (MB) 869, Bankr. L. Rep. (CCH) P 76666A (1995) (setoff "allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding 'the absurdity of making A pay B when B owes A.'" (quoting Studley v. Boylston Nat. Bank of Boston, 229 U.S. 523, 528, 33 S. Ct. 806, 57 L. Ed. 1313 (1913)). See also In re Communication Dynamics, Inc., 382 B.R. 219, 232, 49 Bankr. Ct. Dec. (CRR) 160 (Bankr. D. Del. 2008) ("for the purposes of section 553, a rejection damages claim is a pre-petition claim subject to setoff against any pre-petition debt owed by the creditor to the debtor"). Although there is a split in authority, most courts addressing the issue have found that a rejection damages claim is a prepetition claim subject to setoff. Communication Dynamics, 382 B.R. at 230 (collecting cases).

71. 11 U.S.C.A. § 365(n)(2)(C)(i).

72. Recoupment is an equitable method of adjusting the value of a claim when the damages arise out of the same transaction. See In re University Medical Center, 973 F.2d 1065, 1081, 38 Soc. Sec. Rep. Serv. 482, 23 Bankr. Ct. Dec. (CRR) 628, 27 Collier Bankr. Cas. 2d (MB) 800, Bankr. L. Rep. (CCH) P 74791 (3d Cir. 1992) (rejected by, In re St. Johns Home Health Agency, Inc., 173 B.R. 238, 46 Soc. Sec. Rep. Serv. 52 (Bankr. S.D. Fla. 1994)) (recoupment available only when "both debts… arise out of a single integrated transaction so that it would be inequitable for the debtor to enjoy the benefits of that transaction without also meeting its obligations."); see also Matter of Holford, 896 F.2d 176, 178-79, 20 Bankr. Ct. Dec. (CRR) 416, 22 Collier Bankr. Cas. 2d (MB) 1097, Bankr. L. Rep. (CCH) P 73294 (5th Cir. 1990) (holding that withholding of rent to debtor under lease constituted recoupment, not setoff).

73. See In re Flagstaff Realty Associates, 60 F.3d 1031, 1035, 27 Bankr. Ct. Dec. (CRR) 738, 34 Collier Bankr. Cas. 2d (MB) 152 (3d Cir. 1995) ("In recognition of the special nature of recoupment, courts have permitted its application even in situations where the Code does not permit application of the related doctrine of setoff"); Holford, 896 F.2d at 179 (holding that recoupment does not violate the automatic stay); see also In re Go Fig, Inc., 51 Bankr. Ct. Dec. (CRR) 63, 2009 WL 537090, at *5 n.11 (Bankr. E.D. Mo. 2009) ("Although modern pleading procedure generally has made the distinction between setoff and recoupment less significant, in the bankruptcy context, the difference between the two doctrines remains important").

74. See Flagstaff, 60 F.3d at 1035 (holding that tenants withholding rent under section 365(h)(2) would also be entitled to proceed with their claim under a recoupment theory). Sections 365 (h) and (i) are very similar to equitable recoupment in that they allow offset for damages arising from the same transaction "strictly for the purpose of abatement or reduction of such claim." Sims v. U.S. Dept. of Human Services, 225 B.R. 709, 711 (N.D. Cal. 1998), judgment aff'd, 224 F.3d 1008, 36 Bankr. Ct. Dec. (CRR) 197, 44 Collier Bankr. Cas. 2d (MB) 1533, Bankr. L. Rep. (CCH) P 78264 (9th Cir. 2000) (defining recoupment). Arguably, the statutory right in sections 365 (h) and (i), referenced in section 553 as a setoff right, is narrower than equitable recoupment, however, because equitable recoupment is "not limited to instances involving mutuality of obligation." See Waldschmidt v. CBS, Inc., 14 B.R. 309, 314 (M.D. Tenn. 1981) (comparing setoff under Bankruptcy Act to equitable recoupment and allowing recording company to reduce its postpetition royalties payment to a debtor recording artist by the amount of prepetition advance payments it had made to that artist in anticipation of an album); see also Lee v. Schweiker, 739 F.2d 870, 875, 6 Soc. Sec. Rep. Serv. 98, 11 Collier Bankr. Cas. 2d (MB) 834, Bankr. L. Rep. (CCH) P 69914, Unempl. Ins. Rep. (CCH) P 16982 (3d Cir. 1984) (recoupment "is essentially a defense to the debtor's claim against the creditor rather than a mutual obligation" where application of the limitations on setoff in bankruptcy would be inequitable).

75. See 5 Collier on Bankruptcy, ¶ 553.10 at p. 553-99 (15th rev. ed. 2008) (noting "the tendency of some courts to use the terms 'setoff' and 'recoupment' interchangeably").

76. Given that courts frequently use the terms 'setoff' and 'recoupment' interchangeably, if Congress wished to preserve the right to recoupment after requiring a licensee to waive all rights to setoff in section 365(n)(2)(C)(i), one might expect such rights to be codified. See,

e.g.,Centura Software, 281 B.R. at 668 (referring to sections 365(h), (i), and (n) as all similar in providing "more rights" to parties who contracted with debtors than provided by the general rejection damages rule in section 365(g).).

77. As discussed above, sections 365 (h) and (i) provide rights that are very similar to equitable recoupment, yet are referenced as types of "setoff" in 11 U.S.C.A. § 553(b)(1). This supports the argument that by requiring a licensee to waive any right to "setoff" in 11 U.S.C.A. § 365(n)(2)(C)(i) and not providing for any right for the licensee to offset damages, Congress intended the waiver to bar both setoff claims and the exercise of equitable recoupment. Recoupment has not been addressed in case law interpreting section 365(n) and would de a departure from the typical case where recoupment was applied to allow an adjustment of previously paid funds. See In re Newbery Corp., 145 B.R. 998, 1005, 23 Bankr. Ct. Dec. (CRR) 979, Bankr. L. Rep. (CCH) P 75019 (B.A.P. 9th Cir. 1992), opinion withdrawn, appeal dismissed, 161 B.R. 999 (B.A.P. 9th Cir. 1994) ("most of the cases where recoupment was found to properly apply involved an adjustment of overpaid or advanced funds"). Here, by contrast, a debtor could argue a licensee willingly waived any right to recoupment by electing to retain the use of IP under section 365(n).

78. 11 U.S.C.A. § 365(h)(2)(B) provides a timeshare interest purchaser may offset "the value of any damage caused by the nonperformance after the date of such rejection… but the timeshare interest purchaser shall not have any right against the estate or the debtor on account of any damage occurring after such date by such nonperformance." Likewise, 11 U.S.C.A. § 365(i)(2)(A) contains a similar right of offset for purchasers in the context of sales real property or of timeshare interests, but provides that "such purchaser does not have any rights against the estate on account of any damages arising after such date of such rejection."

79. Lee v. Schweiker, 739 F.2d at 875. See also In re Davidovich, 901 F.2d 1533, 1537, Bankr. L. Rep. (CCH) P 73372 (10th Cir. 1990) (same).

80. Quad Systems, 2001 WL 1843379, at *13 (citing H.R. Rep. No. 1012, 100th Cong., 2d Sess. (1988)).

81. Centura Software, 281 B.R. at 662 (denying licensee's motion to setoff and holding that "once a license has been rejected, the counter-party may not continue to use the trademarks").