Failing Dot.coms

The Dot.com Avalanche from a Bankruptcy Perspective

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Keep Raising the Bar.

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I. AN INTRODUCTI PHENOMENON

The late 1990's were generally an
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Still, at the end of 1994, wh
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1 Source: Administrative Office of the United
http://www.uscourts.gov:80/Press_Releases/ (a

2 Hayden Mead and Brad Hill, The On-line/E-

3 For a fuller discussion of the term 'cyberspa
Wide Web Unleashed, Pgs. 328-333 (2d ed. 19

4 Source: HOBBES' INTERNET TIMELINE
http://www.isoc.org/zakon/Internet/History/HI

Section 5

UNDERSTANDING DOWNSIDE PROTECTION ISSUES IN THE FINANCING AND LICENSING OF IP ASSETS

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Intellectual property assets - copyright, patent, trademark and tradesecrets - are the crown jewels of most 21st century corporations; however, in many instances the value of such IP assets is not fully realized in many financing and licensing transactions. IP assets are often overlooked when a corporation seeks bank or other traditional debt financing because of uncertainty as to how to create a perfected security interest in IP collateral. Without clear guidance on how to perfect security interests in IP assets and without assurance that such security interests will prevail over the claims of attaching creditors or survive challenge in bankruptcy, many lenders are unwilling to make advances on the strength of IP assets. In addition, IP assets are often transferred between corporations pursuant to contractual licensing agreement and in order to realize full value of such IP assets under such arrangements, it is essential that licensors and licensees of IP assets understand the impact of bankruptcy and insolvency laws on licenses of IP assets.

This paper is directed to entities that want to (a) give or accept a security interest in IP assets or (b) enter into IP licensing arrangements. Part I contains a summary of the four traditional categories of IP assets and some basics of the IP laws protecting such assets. Part II discusses the current law governing the creation and perfection of security interests in IP assets and the conflicts existing between traditional IP law (especially copyright) and the law governing secured transactions. Part III discusses the treatment of licensed IP assets in bankruptcy.

I. INTELLECTUAL PROPERTY

The four substantive areas of IP law (copyright, patent, trademark and trade secrets) share one unifying trait: the protection of human ingenuity. Beyond that, the differences in the protections are substantial. For each category of IP asset, set forth below is an overview of the source of law, how rights are obtained under applicable law, the duration of such rights and how such rights are transferred.

A. Copyright

Authors of original works fixed in a tangible medium are entitled, under federal law, to certain exclusive rights in their works for limited periods of time. Copyright law protects such items as music, books, photographs and computer programs.

1. Source of Law

Congress has constitutional authority to "promote the progress of science and useful arts, by securing for limited times to authors and inventors exclusive rights to their respective writings and discoveries." U.S. Constitution, Art. 1, § 8, cl. 8. Pursuant to that authority, Congress passed the nation's current copyright law -- the 1976 Copyright Act (17 U.S.C. §§ 101-810) which completely preempts state law. Regulations implementing the provisions of the statute appear at 37 C.F.R. Parts 201-204. The United States Copyright Office also maintains a very useful website which is accessible at http://lcweb.loc.gov/copyright.

2. Obtaining Copyright Rights

Copyright protection exists immediately and automatically upon the creation of an original work of authorship fixed in any tangible medium of expression. Works of authorship include without limitation:

1. Literary works;
2. Musical works, including any accompanying words;
3. Dramatic works, including any accompanying music;
4. Pantomimes and choreographic works;
5. Pictorial, graphic and sculptural works;
6. Motion pictures and other audiovisual works;
7. Sound recordings; and
8. Architectural works.

17 U.S.C. § 102. Though not specifically listed in Section 102, computer programs are recognized to be entitled to copyright protection. 17 U.S.C. §§ 101, 117. Copyright protection does not extend to any "idea, procedure,

process, system, method of operatic
U.S.C. § 102(b). The rule of thumb
of an idea, not the idea itself.

The owner of a copyright is entitled

1. To reproduce the copyright
2. To prepare derivative work
3. To distribute the copies or
to the public by sale or otl
lease or lending;
4. In the case of literary, musi
pantomimes and motion pi
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5. In the case of a literary,
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6. In the case of sound recorc
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17 U.S.C. § 106 (emphasis added).

Registration with the United States (
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of the Copyright Act. For example,
infringing activity provides the rigł
fees. 17 U.S.C. § 412.

3. Duration of Rights

For works created on or after Janua
from the time of the work's creatioı
the life of the author plus 70 years.
works made for hire, copyright enduı
of its first publication or 120 years f
expires first. 17 U.S.C. § 302(c).

process, system, method of operation, concept, principal or discovery." 17 U.S.C. § 102(b). The rule of thumb is that copyright protects the expression of an idea, not the idea itself.

The owner of a copyright is entitled to the following exclusive rights:

1. To reproduce the copyrighted work in copies or phono records;

2. To prepare derivative works based upon the copyrighted work;

3. To distribute the copies or phono records of the copyrighted work to the public by sale or other transfer of ownership, or by rental, lease or lending;

4. In the case of literary, musical, dramatic and choreographic works, pantomimes and motion pictures and other audiovisual works, to perform the copyrighted work publicly;

5. In the case of a literary, musical, dramatic and choreographic works, pantomimes and pictorial, graphic, or sculptural works, including the individual images of a motion picture or other audio visual work, to display the copyrighted work publicly; and

6. In the case of sound recordings, to perform the copyrighted work publicly by means of a digital audio transmission.

17 U.S.C. § 106 (emphasis added).

Registration with the United States Copyright Office is not a prerequisite to the creation of a copyright. However, registration is a prerequisite to the filing of an infringement action. 17 U.S.C. § 411. Registration is also necessary to record assignments (discussed below) and to obtain other benefits of the Copyright Act. For example, registration prior to the occurrence of infringing activity provides the right to statutory damages and attorneys' fees. 17 U.S.C. § 412.

3. Duration of Rights

For works created on or after January 1, 1978, copyright protection exists from the time of the work's creation and endures for a term consisting of the life of the author plus 70 years. 17 U.S.C. § 302(a). With respect to works made for hire, copyright endures for a term of 95 years from the year of its first publication or 120 years from the year of its creation, whichever expires first. 17 U.S.C. § 302(c).

4. Transfer of Rights/Assignment

Copyright vests initially in the author or authors of the work. 17 U.S.C. § 201. In the case of a work made for hire, the employer or other person for whom the work was prepared is considered the author for purposes of the Copyright Act unless the parties have expressly agreed otherwise in writing. Copyright owners may assign their rights, but before doing so must ensure that the copyright is registered. Section 205(c) of the Copyright Act provides:

Recordation of a document in the Copyright Office gives all persons constructive notice of the facts stated in the recorded document, but only if:

(1) the document, or material attached to it, specifically identifies the work to which it pertains so that, after the document is indexed by the Register of Copyrights, it would be revealed by a reasonable search under the title or registration number of the work; and

(2) registration has been made for the work.

17 U.S.C. § 205(c) (emphasis added).

As between two conflicting transfers, the one executed first prevails if it is recorded in compliance with the Copyright Act within one month after its execution within the United States or within two months after its execution outside the United States, or at any time before recordation in such manner of the later transfer. 17 U.S.C. § 205. Otherwise the later transfer prevails if recorded first in such manner, and if taken in good faith, or valuable consideration or on the basis of a binding promise to pay royalties, and without notice of the earlier transfer.

As discussed below in Part II.A.1, judicial interpretations of Section 205 have unduly complicated the process of perfecting a security interest in copyrights.

B. Patent

Inventors and discoverers of new products and processes are afforded, under federal law and after application and approval, the right to exclude others from making, using or selling the patented invention described in the approved application. Patents can be issued for new, useful and unobvious inventions of statutorily approved subject matters.

1. Source of Law

The Congressional authority to enact
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subsequently amended, is contained a
the United Stated Patent and Tradem
Parts 2-6. The PTO maintains its wet

The Patent Act provides that "whoe
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and useful improvement thereof, may
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within one of the following statutory s

a. process (a term itself definec
art or method, and includes
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b. machine;

c. manufacturer;

d. composition of matter; or

e. any new and useful improvem

In addition, the invention must be nov

Patent law also allows "design" patent
ornamental designs for articles of man
granted for certain distinct and new va

2. Obtaining Patent Rights

Unlike copyright protection, which p
their fixation in a tangible medium of
obtained after approval of an applicati
plication is filed, the PTO conducts an
viewed and a determination is made as
If the examiner rejects the application,
submission for re-examination. Dispu
ent are subject to administrative proce
judicial proceedings.

3. Duration of Rights

The Congressional authority to enact patent legislation is based on the Constitutional clause noted above. The current Patent Act, enacted in 1952 and subsequently amended, is contained at 35 U.S.C. §§ 1-376. Regulations of the United Stated Patent and Trademark Office ("PTO") appear at 37 CFR Parts 2-6. The PTO maintains its website at www.uspto.gov.

The Patent Act provides that "whoever invents or discovers any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof, may obtain a patent therefore." 35 U.S.C. § 101. Thus, to be eligible for patent protection, an invention must, first, fit within one of the following statutory subject matters listed in Section 101:

a. process (a term itself defined by the Patent Act to mean "process, art or method, and includes a new use of a known process, machine, manufacture, composition of matter, or material");

b. machine;

c. manufacturer;

d. composition of matter; or

e. any new and useful improvement on any of the above.

In addition, the invention must be novel, useful and unobvious.

Patent law also allows "design" patents to be granted for new, original and ornamental designs for articles of manufacture and for "plant patents" to be granted for certain distinct and new varieties of plants.

2. Obtaining Patent Rights

Unlike copyright protection, which protects the expression of ideas upon their fixation in a tangible medium of expression, patent rights can only be obtained after approval of an application filed with the PTO. Once an application is filed, the PTO conducts an examination in which prior art is reviewed and a determination is made as to whether a patent should be issued. If the examiner rejects the application, the applicant may make a timely resubmission for re-examination. Disputes about the PTO's action on a patent are subject to administrative proceedings in the PTO and then federal judicial proceedings.

3. Duration of Rights

Utility patents have a term of 20 years from filing. 35 U.S.C. § 154(a)(2). In certain instances, a one time extension of 5 years may be granted § 154(b). Design patents have a term of 14 years. 35 U.S.C. § 173.

4. Transfer of Rights/Assignments

The Patent Act makes clear that ownership of a patent always initially vests in the inventor or inventors and that patents have the attributes of personal property. Section 261 states:

Applications for patent, patents or any interest therein shall be assignable in law by an instrument in writing. The applicant, patentee, or his assigns or legal representatives, may, in like manner, grant and convey an exclusive right under his application for patent, or patents, to the whole or any specified part in the Untied States.

A certificate of acknowledgment [subject to notarization in the United States or abroad] shall be prima facie evidence of the execution of an assignment, grant or conveyance of a patent or application for a patent.

An assignment, grant or a conveyance shall be void as against any subsequent purchaser or mortgagee for a valuable consideration, without notice, unless it is recorded in the Patent and Trademark Office within three months from its date or prior to the date of such subsequent purchase or mortgage.

As discussed below in Part IIA, the courts that have addressed the issue have concluded that the above statutory language is materially different from Section 205 of the Copyright Act. As a result, perfection of a security interest in a patent is considered easier for a secured lender to achieve than perfection in copyrights.

C. Trademark

A trademark is a word, phrase, design, sound or symbol used on or in association with a good or service. A mark serves to identify the source of a good or service and to embody a standard of quality. Sellers of goods and services who use brand names to identify and distinguish their products are entitled, under both state and federal law, to various rights to exclude others from using a similar mark in a way likely to be confusing to a consumer. Trademark law protects such trademarks as Xerox, Ford, and Coca-Cola.

1. Sources of Law

There is no specific Constitutional so
late on the subject of trademarks. A
Interstate Commerce Clause as a sou
trademark law is the Lanham Act, pa
hensively revised in 1988), which is
The PTO has issued regulations loca
website, given above, contains useful

The Lanham Act, unlike the Patent
empt state law. Indeed, trademark r
The Lanham Act simply provides a
rights in trademarks used in interstate
have enacted state registration statute
event of alleged infringement.

2. Obtaining Trademark Rights

Trademark rights are most fundamen
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The benefit of federal registration is
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or in connection with the goods and
15 U.S.C. § 1057(b). Moreover, the
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only to certain enumerated defenses.

Trademark rights exist only in connec
business. Thus, a transfer of a tradem
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goodwill, then the transfer will be c
gross."

3. Duration of Rights

There is no specific Constitutional source for Congress' authority to legislate on the subject of trademarks. As a result, Congress has relied on the Interstate Commerce Clause as a source of authority. The current federal trademark law is the Lanham Act, passed originally in 1946 (and comprehensively revised in 1988), which is codified at 15 U.S.C. §§ 1051-1128. The PTO has issued regulations located at 37 CFR Parts 1-7. The PTO website, given above, contains useful information about trademarks.

The Lanham Act, unlike the Patent Act and Copyright Act, does not preempt state law. Indeed, trademark rights arise under state common law. The Lanham Act simply provides a mechanism for the enforcement of rights in trademarks used in interstate commerce. Similarly, various states have enacted state registration statutes that provide certain benefits in the event of alleged infringement.

2. Obtaining Trademark Rights

Trademark rights are most fundamentally established by <u>using</u> a mark in commerce. As noted above, once used in commerce, trademark owners may seek registration under state trademark registration laws in jurisdictions in which the mark is used and under the Lanham Act provided the mark is used in interstate commerce. (The Lanham Act also allows an intent to use application to be filed in certain cases up to six months prior to actual use.)

The benefit of federal registration is the grant of additional rights to the trademark owner throughout the United States, federal jurisdiction and a means of providing constructive notice. Specifically, the Lanham Act provides that a certificate of registration of a mark upon the principal register "shall be prima facie evidence of the validity of the registered mark and of the registration of the mark, of the registrant's ownership of the mark, and of the registrant's exclusive right to use the registered mark in commerce on or in connection with the goods and services specified in the certificate." 15 U.S.C. § 1057(b). Moreover, the registration exists as "conclusive evidence of the validity of the mark, of the registrant's ownership of the mark, and of the registrant's exclusive right to use the mark in commerce" subject only to certain enumerated defenses. 15 U.S.C. § 1115(b).

Trademark rights exist only in connection with the goodwill of the owner's business. Thus, a transfer of a trademark must also be accompanied by the transfer of the goodwill of the business in order to be valid. If a court concludes that the transfer of a mark was made without the mark's associated goodwill, then the transfer will be considered void as an "assignment in gross."

3. Duration of Rights

Unlike copyright and patent rights which are granted only for limited periods of time, a trademark has a potentially unlimited life. However, an owner that fails to use and protect the mark risks the loss of ownership. Registrations are renewable indefinitely.

4. Transfer of Rights/Assignment

Section 1060 of the Lanham Act voids any assignment of rights in a federally registered mark against a subsequent purchaser for value without notice unless certain prescribed information reporting the assignment is recorded with the PTO within three months after the effective date of the assignment or prior to such purchase.

D. Trade Secrets

State law provides protections to owners of formulas, patterns, devices of compilation of information used in business, kept secret and that provide an advantage over competitors.

1. Source of Law

Trade secret protection arises from state law and contractual obligations. The Restatement of Torts § 757 states that a trade secret may consist of any "formula, patent, device or compilation of information which is used in one's business, and which gives him an opportunity to obtain an advantage over competitors who do not know or use it." The Uniform Trade Secrets Act has been adopted in 32 states and the District of Columbia. The Uniform Act defines a trade secret as information that has "independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use."

2. Obtaining Trade Secret Rights

Trade secret rights are acquired by the person or entity responsible for developing the secret or acquiring it lawfully. Whether information in fact qualifies as a trade secret requires an analysis of the definitions provided above, or in the applicable jurisdiction.

3. Duration of Rights

Like trademarks, trade secrets can have an unlimited life. However, once a secret becomes known to the public or available to it, the information is no longer protectable as a trade secret.

4. Transfer of Rights/Assignment

Trade secret information may be trar
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II. SECURITY INTEREST

Valuable IP assets are often offered up b
lender to extend financing. Unfortunatel
curity interest in IP assets is not accompl
the state of the current law of secured tra
Uniform Commercial Code ("UCC"); Par
cle 9, which many expect to be in effect
on IP financing transactions; Part C disc
their potential impact on the perfection of

A. Current Article 9

Lenders who seek to obtain a consen
personal property collateral must com
cle 9, enacted as state law in every st
to be "general intangibles" under the
intangibles must be perfected by the
appropriate UCC filing office -- typic
and/or a local city or town clerk's of
tain filings under a federal statute ma
ticle 9. Specifically, Section 9-302(a)

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> or a national or internati
> title or which specifies
> different from that speci
> for filing of the security

Uncertainty has arisen over the proper me
to the existence of the federal legislation
marks discussed in Part I.

4. Transfer of Rights/Assignment

Trade secret information may be transferred as long as reasonable precautions are taken by both the transferee and the transferor to maintain the secrecy.

II. SECURITY INTERESTS IN IP ASSETS

Valuable IP assets are often offered up by a company as collateral to induce a lender to extend financing. Unfortunately for all involved, the granting of a security interest in IP assets is not accomplished simply. Part A below discusses the state of the current law of secured transactions, set forth in Article 9 of the Uniform Commercial Code ("UCC"); Part B discusses the impact Revised Article 9, which many expect to be in effect nationwide on July 1, 2001, will have on IP financing transactions; Part C discusses other legislative initiatives and their potential impact on the perfection of security interests in IP assets.

A. Current Article 9

Lenders who seek to obtain a consensual security interest in most types of personal property collateral must comply with the procedures of UCC Article 9, enacted as state law in every state. IP assets are generally considered to be "general intangibles" under the UCC. A security interest in general intangibles must be perfected by the filing of a financing statement in the appropriate UCC filing office -- typically, a state secretary of state's office and/or a local city or town clerk's office. Yet, Article 9 provides that certain filings under a federal statute may satisfy the filing requirements of Article 9. Specifically, Section 9-302(a) provides that:

> The filing of a financing statement otherwise required by this Article is not necessary or effective to perfect a security interest in property subject to a statute or treaty of the United States which provides for a national or international registration or a national or international certificate of title or which specifies a place of filing different from that specified in this Article for filing of the security interest.

Uncertainty has arisen over the proper method to perfect a security interest due to the existence of the federal legislation covering copyright, patents and trademarks discussed in Part I.

1. Copyright

As noted in Part I, copyright law is governed by the 1976 Copyright Act. To what extent does the federal statute pre-empt Article 9? That question has been at the heart of several controversial court decisions.

In the leading case, In re Peregrine Entertainment, Inc., 116 B.R. 194 (Bankr. C.D. Calif. 1990), the borrower's principal assets were a library of copyrights, distribution rights and licenses to approximately 145 films and related rights to accounts receivable from its licensing arrangements. The lender sought to secure its $6 million loan through the filing of UCC-1 financing statements with various state filing offices. After the borrower filed for chapter 11 protection, it sought to avoid the lender's security interest on the grounds that the lender was required to file a notice of its security interest in the U.S. Copyright Office.

The Court held that "the comprehensive scope of the federal Copyright Act's recording provision, along with the unique federal interests they implicate, support the view that federal law preempts state methods of perfecting security interests in copyrights and related accounts receivable." The lender, then, was unsecured. Although the Peregrine facts presumably involved only registered copyrights, its holding was not so limited.

Peregrine was followed by In re AEG Acquisition Corp., 127 B.R. 34 (Bankr. C.D. Cal. 1991), aff'd, 161 B.R. 50 (BAP 9th Cir. 1993). In that case, a secured lender that duly filed relevant UCC financing statements with appropriate state offices and a copyright mortgage with the U.S. Copyright Office was nonetheless deemed unperfected because the underlying copyrights were not registered. The Court noted that the lender's recording of a security interest in the Copyright Office was ineffective absent a prior registration of the relevant copyright with the Copyright Office. A similar rule was acknowledged in In re Avalon Software, Inc., 209 B.R. 517 (D. Ariz. 1997), where the copyrights (relating to computer software) were not registered and the lender failed to file in the Copyright Office.

The AEG decision has been rejected recently in Aerocon Engineering Inc. v. Silicon Valley Bank, (In re World Auxiliary Power Company, et al), 244 B.R. 149 (Bankr. N.D. Cal. 1999). After discussion of Peregrine, AEG and Avalon, the Court concluded that "[w]hen a copyright is unregistered, a secured creditor may perfect its security interest by filing a UCC-1 financing statement with the UCC Office." The holding raises the interesting question of whether a secured lender with a duly filed UCC financing statement on unregistered copyrights will lose its perfected status upon its borrower's registration of the copyrights with the Copyright Office.

Even if a lender can attain comfort th
fices, it must confront other difficultie
interest in copyrights. Chief among
ment recorded with the Copyright Offi
which it pertains." Thus, separate fi
item appears necessary. In addition, a
nized and enforceable under Article 9
under the Copyright Act.

2. Patents

As noted above in Part I, patent law i
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ent statute is In re Transportation I
(Bankr. S.D. Cal. 1985). In that case,
in all "general intangibles" and filed a
appropriate state filing office. In th
trustee contended that the lender was
because it had failed to record the secu
tee argued that federal recordation was
the patent statute (set forth in Part I.B4

The Bankruptcy Court concluded that
ent statute governed the rights only of
gagees", not trustees in bankruptcy. 3
reached in Chesapeake Fiber Packagi
143 B.R. 360 (D. Md. 1992), aff'd, 8
re Cybernetic Services, 239 B.R. 917 (

All commentators agree that parties s
interest in a patent and protection aga
both under the UCC and with the PTO

3. Trademark

Part I above noted that trademark righ
are registerable under either state or fe
enough, a trademark created under sta
trademark is perfected by the filing of
Because a trademark cannot be sold o
represents, the security agreement an
cally include both the debtor's tradema
business associated with such tradem
will accept a copy of the financing st
require any filing other than in the spe

Even if a lender can attain comfort that it has filed in all relevant filing offices, it must confront other difficulties that exist with perfecting a security interest in copyrights. Chief among these is the requirement that a document recorded with the Copyright Office "specifically identif[y] the work to which it pertains." Thus, separate filings for each individual copyrighted item appears necessary. In addition, after-acquired property clauses, recognized and enforceable under Article 9, appear to be of no force and effect under the Copyright Act.

2. Patents

As noted above in Part I, patent law is governed by the federal patent statute. The leading case considering the intersection of Article 9 and the patent statute is In re Transportation Design & Technology, 48 B.R. 635 (Bankr. S.D. Cal. 1985). In that case, the lender claimed a security interest in all "general intangibles" and filed a UCC-1 financing statement with the appropriate state filing office. In the bankruptcy case of borrower, the trustee contended that the lender was unperfected with respect to a patent because it had failed to record the security interest with the PTO. The trustee argued that federal recordation was necessary pursuant to Section 261 of the patent statute (set forth in Part I.B4 above).

The Bankruptcy Court concluded that the plain language of the federal patent statute governed the rights only of the "bona fide purchasers" or "mortgagees", not trustees in bankruptcy. 35 U.S.C. § 261. The same result was reached in Chesapeake Fiber Packaging Corp. v. Sebro Packaging Corp., 143 B.R. 360 (D. Md. 1992), aff'd, 8 F.3d 817 (4th Cir. 1993). See also In re Cybernetic Services, 239 B.R. 917 9th Cir. BAP 1999).

All commentators agree that parties seeking to obtain a perfected security interest in a patent and protection against bona fide purchasers, should file both under the UCC and with the PTO.

3. Trademark

Part I above noted that trademark rights arise under state common law and are registerable under either state or federal registration systems. Naturally enough, a trademark created under state common law or a state registered trademark is perfected by the filing of a financing statement under the UCC. Because a trademark cannot be sold or assigned apart from the goodwill it represents, the security agreement and financing statement should specifically include both the debtor's trademark and the associated goodwill of the business associated with such trademark. Some state registration offices will accept a copy of the financing statement, although the UCC does not require any filing other than in the specified UCC filing office.

There are several leading cases concluding that the Lanham Act does not preempt the UCC with respect to the perfection of security interests in trademarks. Thus, based on the reported decisions, perfection of a security interest in a federally registered trademark is accomplished by the filing of a UCC financing statement under Article 9 of the UCC against general intangibles.

For example, in In re TR-3 Industries, 41 B.R. 128 (Bankr. C.D. Calif. 1984), the lender had filed a financing statement covering general intangibles of the debtor but had made no security assignment filing in the PTO. The Bankruptcy Court rejected the creditors committees' arguments that the lender was unperfected. Similarly, in In re Roman Cleanser Co., 43 B.R. 940 (Bankr. E.D. Mich. 1984), aff'd, 802 F.2d 207 (6th Cir. 1986) the Court concluded that the Lanham Act contemplates the registration only of outright assignments, not collateral assignments for security. The Sixth Circuit affirmed the lower court's decision and held that the failure of the security interest to cover machinery and equipment needed to produce the trademarked goods did not transform the grant of a security interest in the trademark to an impermissible assignment in gross. See also In re 199Z Inc., 137 B.R. 778 (C.D. Calif. 1992) (holding that the Lanham Act does not contemplate the recording of security interests at the federal level and that the term "assignment" in Section 1060 of the Lanham Act does not include pledges, mortgages or other hypothecations of trademarks).

The Bankruptcy Court in the District of Massachusetts reached a similar result in In re Together Development Corporation, 227 B.R. 439 (Bankr. D. Mass. 1998). In that decision, the Bankruptcy Court concluded that the term "assignment" was not broad enough to include the granting of a consensual lien. The Court held that the creditor's failure to file a financing statement with the appropriate UCC filing office was fatal. Filing with the PTO is necessary to cut-off the rights of bona fide purchasers.

4. Trade Secrets

Trade secrets arise under state law and are treated as general intangibles for purposes of Article 9. Accordingly, a security interest in trade secrets is perfected by filing a UCC-1 financing statement in the appropriate state filing offices.

B. Revised Article 9

The National Conference of Commissions and Uniform State Laws ("NCCUSL") granted final approval to a revised version of Article 9 during the summer of 1998. To date, the revised Article 9 has been passed by sev-

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enteen states and is scheduled to become effective on July 1, 2001. The status of state adoptions of revised Article 9 is available at the NCCUSL's website at: www.nccusl.org. Revised Article 9, in the words of leading commentators, "makes a number of important changes in the law of secured transactions, but nothing drastic. Although there are a number of important substantive changes, for the most part, the revision fine tunes, modernizes and clarifies ambiguities of current Article 9 that litigation has revealed." Barclay Clark, Barbara Clark Special Report: New Article 9, Clarks' Secured Transactions Monthly Volume 14, No. 5, July 1998.

As a preliminary matter, Revised Article 9 does not contain any provision clarifying when filings need to be made with the Copyright Office or the PTO. Other legislative initiatives are pending to address that issue (see below). Revised Article 9 does apply, however, to certain types of financing arrangements involving the rights of a licensee of intellectual property. Revised Article 9 only applies, of course, if the financing structure creates a security interest. It will not apply if the transaction does not give rise to a security interest. In such a case, other law (including perhaps the Uniform Computer Information Transactions Act ("UCITA") discussed below) may apply.

The essence of whether a transaction creates a security interest is whether an interest is granted to the lender by the borrower in its personal property or fixtures to secure payment or performance of an obligation (UCC Section 1-201(37)). Thus, the right of a licensor to terminate the license upon default is not a security interest. See generally, S. Weise, The Financing of Intellectual Property Under Revised UCC Article 9, 74 Chi.-Kent Law Review 1077 (1999).

Two of the significant changes made by Revised Article 9 with respect to IP assets are discussed below.

First Revised Section 9-102(a)(2) expands the definition of "account" to include, among other things, payment obligations arising out of licenses. The sale of "accounts" continues to be within the scope of Article 9. Revised Section 9-109(a)(3). Thus, under Revised Article 9, the sale of a licensor's rights to payment under a license constitutes a security interest within the scope of Revised Article 9 and a financing statement must be properly filed to perfect the buyer's interests in such payments. A corresponding provision of Revised Article 9 renders unenforceable any restriction in a license precluding the licensor from assigning its right to payment (Rev. Art. 9-406).

Secondly, Revised Article 9 also explicitly enables a licensee of IP assets to obtain financing collateralized by its rights under the license. Section 9-

408(a) renders unenforceable any provision in a license that impairs the creation, attachment or perfection of a security interest in the rights held under the license. Section 9-408(d), designed to protect the ability of the licensor to control the licensed IP, provides that the licensee's secured party is not entitled to enforce the license or to use, assign or otherwise enjoy the benefits of the licensee if the license so provides.

C. LEGISLATIVE INITIATIVES

1. UCITA

The National Conference of Commissioners on Uniform State Laws approved UCITA in the summer of 1999. Currently, various efforts are underway across the nation to enact -- or block enactment -- of the proposed law. UCITA is controversial and its future is not certain. To date, it has been enacted in Maryland and Virginia and introduced in a handful of other jurisdictions. The NCCUSL website (NCCUSL.org) keeps a current count.

UCITA is drafted to apply to contracts in computer information. A complete description is beyond this paper's scope. As it pertains to financing, the official text of UCITA makes clear that to the extent of a conflict between UCITA and Revised Article 9, Revised Article 9 governs. UCITA Section 103(c). Sections 507-511 of UCITA contain provisions addressing software financing transactions not subject to Article 9.

2. Federal Intellectual Property Security Act ("FIPSA")

The uncertainty concerning the perfection of a security interest in IP assets has led numerous groups to propose legislative changes. One effort, FIPSA, was submitted to a congressional subcommittee in 1999, but never introduced as legislation. FIPSA would permit state UCC filings against IP assets to establish perfection against other secured parties and lien creditors. It would also improve federal recordation systems and require federal filings to establish priority over bona fide purchasers and other transferees. At some point, a legislative fix may be implemented, but in the meanwhile, IP intensive companies -- particularly copyright owners -- will face obstacles in obtaining financing.

III. BANKRUPTCY ISSUES

No company likes to contemplate the prospect of its own financial difficulty or the difficulty of a key licensor or licensee. Yet, to appreciate the issues of concern to a financier it is useful to have some background knowledge of corporate

bankruptcy issues. Moreover, a company
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1. Chapter 7

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2. Chapter 11

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bankruptcy issues. Moreover, a company needs to understand how to protect itself in the event of a meltdown by a key licensor or licensee.

This section begins with a brief introduction to Chapter 7 and Chapter 11 and then provides a short summary of the treatment of contracts, including IP licenses, in bankruptcy.

A. Types of Proceedings; Automatic Stay

Business bankruptcies can be commenced under either Chapter 7 or Chapter 11 of the United States Bankruptcy Code. Bankruptcy cases are commenced in United States Bankruptcy Courts located in each federal judicial district. A financially distressed business may avail itself of state insolvency procedures such as receivership or an assignment for the benefit of creditors, but an understanding of the federal bankruptcy laws is the proper place to begin for the basics.

1. Chapter 7

A bankruptcy proceeding under Chapter 7 is a liquidation case. A Chapter 7 trustee is appointed who has the duty to collect and liquidate the assets of the estate and to distribute the proceeds of the liquidation to creditors. In a typical Chapter 7 case, the debtor files a petition in which it lists all of its assets and all of its debts and a statement of affairs and other schedules disclosing background and budgetary information. An interim trustee is appointed by the United States Trustee and notice is given to creditors of the bankruptcy filing and the first meeting of creditors. Unless a different trustee is elected, the interim trustee normally becomes the trustee in the Chapter 7 case. The trustee takes possession of non-exempt assets, liquidates those assets and distributes the available funds to the creditors in the order of priority set forth in the Bankruptcy Code.

2. Chapter 11

Chapter 11 is the principal reorganization chapter of the Bankruptcy Code and may be used by most entities, including partnerships, corporations and individuals. Normally, the debtor remains in possession of its assets in a Chapter 11 case and no trustee is appointed. Trustees are normally only appointed in a Chapter 11 case if the debtor exhibits dishonesty or gross incompetence.

The ultimate objective of a debtor in a Chapter 11 reorganization case is to obtain court approval of a plan of reorganization which restructures prepetition debt. In the process of obtaining plan approval from creditors and the court, the debtor may ask creditors to grant more favorable repayment terms than existed prebankruptcy. If a creditor is unwilling to grant concessions to the debtor, the debtor may be able to force a creditor or a group of creditors to grant certain concessions through the "cramdown" provisions of the Bankruptcy Code.

3. Automatic Stay

The Code provides that the commencement of a Chapter 7 or 11 case (by a voluntary petition by the debtor or an involuntary petition by creditors) acts as an automatic stay, or injunction, against a wide variety of debt collection and lien enforcement activities a creditor may be pursuing or considering, including the following:

- The commencement or continuation of all judicial, administrative, or other proceedings against the debtor to recover on a pre-petition claim;
- The enforcement of pre-petition judgments;
- Actions to obtain possession or to create, perfect, or enforce liens against any property of the debtor's estate; and
- Any acts to collect or recover on pre-petition claims, or to set off debts owed by the creditor to the debtor.

The stay is aimed at halting, at least temporarily, all litigation, foreclosure, and other creditor enforcement activities against the debtor. The stays provides the debtor with a "breathing spell," during which it may attempt to reorganize its operations and affairs for the benefit of creditors. The automatic stay voids any actions which violate it, and under certain circumstances, provides penalties for violators.

B. Creditor Rights under an Executory Contract with the Debtor

The Code contains special provisions regarding executory contracts and unexpired leases. Although there is no definition of an executory contract in the Code, it is generally regarded as a contract "on which performance is due to some extent on both sides." A contract that has been terminated or that has expired before the commencement of a bankruptcy case is not executory. Note, however, that the Code nullifies any provision in a contract that allows a nondebtor to terminate the contract on the grounds of the insolvency or bankruptcy filing of the debtor.

1. In General

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2. Intellectual Property Licenses

a. Special Rules for Licensor Bankru

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1. In General

Under section 365 of the Code and with court approval, a debtor may: (i) reject an executory contract or unexpired lease; (ii) assume an executory contract or unexpired lease; or (iii) in a Chapter 11 proceeding, if the debtor neither rejects nor assumes a contract, let the contract "ride through" the reorganization and leave the rights of the parties thereunder unchanged upon the emergence of the debtor from Chapter 11. With limited exceptions (see 2(b) below) and subject to certain requirements, the debtor may assume any executory contract or lease even though the debtor is, at the time, in default under such contract or lease. Upon assumption, the agreement is in full force and effect and binding on the debtor as well as on the non-debtor; a debtor who assumes a contract receives not only the benefits of the contract, but also must undertake any burden or obligations under the contract.

Alternatively, the debtor may reject the agreement rendering it prospectively unenforceable; a debtor cannot reject a contract, and still assert rights under provisions of the agreement. Rejection of an agreement constitutes a breach, which is deemed to occur just prior to the bankruptcy filing and entitles the non-debtor to assert a pre-petition claim for damages against the estate; such claim is treated as a general unsecured claim.

A debtor does not need to decide to assume or reject an executory contract immediately. In Chapter 7 liquidation cases, a contract is deemed rejected unless it is assumed within sixty days after the order for relief is entered or within such additional time as the court permits. In Chapter 11 reorganization proceedings, the debtor has until confirmation of the plan of reorganization to assume or reject executory contracts or leases, other than leases of non-residential real estate, which are subject to a sixty day limit subject to extension for cause. If the non-debtor insists, the bankruptcy court may, under appropriate circumstances, require the debtor to decide within a shorter period whether to assume or reject.

2. Intellectual Property Licenses

a. Special Rules for Licensor Bankruptcy Cases

The application of the above general rules had devastating consequences to an IP licensee in Lubrizol Enterprises v. Richmond Metal Finishers, 756 F.2d 1043 (4th Cir. 1985), cert. denied, 106 S.Ct. 1284 (1986). In that case, the debtor owned a unique metal coating process. Pre-petition, it granted a non-exclusive license to Lubrizol Enterprises to use the process. One year after entering into the license agreement, the debtor filed for bankruptcy protection and sought to reject the license agreement. The Fourth Circuit concluded that the license agreement was executory as to both parties and could be rejected by the debtor. The rejection stripped Lubrizol of all of its rights to the licensed technology and left it with a claim for damages against the estate in accordance with the general rules set forth above. In the concluding paragraph of its opinion, the Fourth Circuit noted that its decision would impose a serious burden on Lubrizol and could have a chilling effect upon the willingness of parties to enter into contracts with businesses in possible financial difficulty. Nevertheless, the Fourth Circuit thought that it was up to Congress, not the judiciary to remedy the situation.

In true democratic fashion, Lubrizol and other licensees appealed to Congress to remedy the situation. In response, Congress passed the Intellectual Property Bankruptcy Protection Act ("IPBPA") in 1988. The Act added a definition of "Intellectual Property" to Section 101 of the Bankruptcy Code and also a new section (n) to Section 365 governing executory contracts. Intellectual property is defined to mean the following:

(A) trade secret;

(B) invention, process, design, or plant protected under Title 35 [The Patent Act];

(C) patent application;

(D) plant variety;

(E) work of authorship protected under Title 17 [The Copyright Act]; or

(F) mask work protected under Chapter 9 of Title 17; to the extent protected by applicable nonbankruptcy law.

11 U.S. C. § 101(35A).

Section 365(n) provides two options for a licensee under an IP license in the event that the licensor files for bankruptcy and rejects the license in its bankruptcy case. First, the licensee may treat the license as terminated and file a general unsecured claim against the bankruptcy estate for breach of contract damages, in which case it will forfeit all rights to continued use of the intellectual property relating to the license.

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b. Restrictions on Assumption ai

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Section 365(c)(1) has been used
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Alternatively, the licensee may opt to retain its rights under the license to the technology, including rights of exclusivity. The licensee may retain these rights for the initial term of the contract as well as for any optional extension periods available at the licensee's discretion, but must continue to pay all royalties due the licensor. The licensee is deemed to waive any rights of setoff it might have against the licensor as well as any administrative claims against the estate that it might have. Rejection relieves the debtor licensor of any burdens to take on any additional affirmative action pursuant to the license, such as training of licensee users or updating the intellectual property.

Two limitations on the scope of the IPBPA must be emphasized: (1) the definition of "intellectual property" does not include trade marks and trade names and (2) it does not address what happens when a licensee files for bankruptcy protection. In the latter case, the general rules concerning rejection, assumption and assignment will apply.

b. Restrictions on Assumption and Assignment

The general rules regarding assumption and assignment are subject to one provision that has had significant importance to the determination of IP rights in bankruptcy. Specifically, Section 365(c)(1) of the Code recognizes that certain types of contracts should not be subject to assumption and assignment over a licensor's objection when applicable nonbankruptcy law excuses the nondebtor from accepting performance. The classic example of a contract that is not subject to assumption and assignment is a personal services contract. State law allows a nondebtor to refuse acceptance of performance from anybody other than the original contracting party -- and the Code honors that result. Litigation has occurred over what other type of law excuses acceptance of performance. The law seems well settled that a patent license agreement may not be assigned without the consent of the licensor. <u>See</u> <u>Everex Systems, Inc.</u> v. <u>Cedtrak Corp.</u>, 89 F3d 673 (9th Cir. 1996). There is less certainty concerning whether copyright and trademark law excuses a licensor from accepting performance from a third party. One copyright case borrows from patent law and states that a licensor may refuse performance; one trademark case found that the particular trademark license at issue had significant protections for the licensee and allowed the agreement to be assigned. <u>See</u> <u>In re Patent Education Media, Inc.</u>, 210 B.R. 237 (Bankr. S.D.N.Y. 1997); <u>In re: Rooster</u>, 100 B.R. 728 (Bankr. E.D. Pa. 1989).

Section 365(c)(1) has been used successfully by some licensors to prevent not only assignment of their IP licenses, but to also prevent mere assumption by the debtor. Two circuit courts of appeal and the Bankruptcy Court for Delaware have concluded that a debtor that has no ability to assign an IP contract also lacks the ability to assume such a contract. These decisions (see e.g. In re Access Beyond Technologies, 237 B.R. 32 (Bankr. D. Del. 1999)) place incredible leverage in the hands of licensors by allowing them to seek to obtain control of the license once a licensee files. Other courts have rejected that holding and instead allow a debtor to assume an IP license if it has no actual intent to assign but instead will continue to perform itself. See Institute Pasteur v. Cambridge Biotech Corp., 104 F3d 489 (1st Cir. 1997), cert. denied, 521 U.S. 1120 (1997).

CONCLUSION

The popular press is full of stories about a dot com shakeout. In instances such as toysmart.com and craftshop.com, financiers have proven that limits exist to funding losses. Any entity interested in leveraging value out of its IP assets -- whether by granting security interests or entering into license agreements -- needs to understand the downside protection issues that its potential contract party will be focused on. This paper has identified the range of issues that should be central in IP asset leveraging discussions.

Section 6

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[1] John Loughnane acknowledges the assistance of Peter Bilowz