The Pitfalls and Perils of Nonprofit Licensing When a Licensee is Facing Bankruptcy

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I. Introduction

The licensing of intellectual property rights produces staggering amounts of revenue worldwide each year. As countries around the globe continue to appreciate and develop their intellectual property portfolios, licensing efforts increase proportionally. Nonprofit institutions such as universities, teaching hospitals, research institutes, and patent management firms are contributing to this licensing explosion thanks largely in part to the passage of the Bayh-Dole Act in 1980.

As a result of Bayh-Dole, nonprofit institutions retain title to inventions created through the use, in whole or in part, of government funds.[1] Universities are increasingly seeking to license patented technology in hopes of revenue for continuing education and research. These efforts are evidenced by a glance through the licensing statistics surrounding nonprofits since 1980.

Today, universities alone receive approximately 3% of all the United States' origin patents issued.[2] Not only is the number of patents issued increasing, the number of universities recognizing the benefits of retaining title has increased significantly. Of course, having a patent issued is just half of the battle. One of the key goals of Bayh-Dole is for the nonprofit to license technology to the private sector for development into products for the improvement of society. This activity has been evidenced by a 2002 Association of University Technology Managers (AUTM) survey. This survey reported that 81% of the total 222 respondents had 5,085 licenses in place that generated continuous royalties.[3] The passage of Bayh-Dole has also contributed to over 2,000 new products being launched since 1998.[4]

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[1] 37 C.F.R. § 401.14 (c)(2) (2004).

[2] See Howard W. Bremer ,University Technology Transfer Evolution and Revolution. (Winter ed., COGR 2000).

[3] AUTM Survey (2002), *at* http://www.autm.net/index_ie.html

[4] *Id.*

As per Bayh-Dole, nonprofits are expected to give licensing preference to small businesses.[5] Some nonprofits, namely universities, have even chosen to negotiate licensing arrangements with start-up companies. Unfortunately, the economic woes of the past few years have put a strain on the licensing relationship between universities and start-ups. Companies with allegedly foolproof business plans have seen their efforts to commercialize a licensed technology evaporate in the face of bankruptcy. Start-up companies have experienced significant difficulties due to a lack of cash flow and impending loss of venture capital. These situations have put the nonprofit licensor in a very compromising position. The bankruptcy of the licensee also poses a serious threat to the licensor's control over the assignability of the licensed rights.

This paper will address the evolution and application of both the statutory and plethora of contradictory case law pertinent to the fate of intellectual property licenses in bankruptcy. This paper will also point out the numerous pitfalls nonprofit licensing professionals need to be aware of in the event a licensee files for bankruptcy. This paper will also propose strategies to dispose of these problems before they arise. Finally this paper will offer a solution to the tension that currently exists among the circuits as to the fate of intellectual property licenses in the event of bankruptcy.

II. Applicable Law

A. Bankruptcy Law: Generally

Bankruptcy occurs as a result of a firm being financially unable to pay debts and meet financial obligations. Bankruptcy law's principal objective is to make the best use of the debtor's estate in order to maximize payments to creditors and to provide the debtor with a second opportunity at financial success. For ease of operation and consistency, Congress granted bankruptcy law exclusively to the federal court system.[6] To further achieve this goal, Congress created specialized bankruptcy courts.

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[5] 37 C.F.R. § 401.14 (k)(4) (2004)

[6] See U.S. Const. art. I, § 8, cl. 4 (granting Congress the power "to establish . . . uniform Laws on the subject of Bankruptcies throughout the United States").

A Chapter 11 bankruptcy enables a company to restructure its balance sheet by terminating contracts or renegotiating obligations with onerous terms.[7] A start-up company may voluntarily enter Chapter 11 bankruptcy to clean up its financials before an IPO by renegotiating more favorable terms on its debt or lease obligations. In addition to being used by financially distressed companies, bankruptcy law is increasingly used to limit successor liability and to provide clear title to assets by forcing creditors to renegotiate debt arrangements or executory contracts such as leases. Therefore, nonprofits who regularly negotiate intellectual property licenses with start-up companies should be mindful of a licensor's ability to use bankruptcy law as a tool to reduce uncertainty in potential acquisitions or to improve their financials pre-IPO.

B. The Evolution and Application of the Applicable Statutory Provisions

The law governing intellectual property licenses in bankruptcy received plenty of attention in the mid to late 1980's. The roller coaster ride began with the decision of the Fourth Circuit Court of Appeals in *Lubrizol Enterprises v. Richmond Metal Finishers*.[8] This decision received plenty of negative commentary by licensees whose core business relied on licensed technology. In this case, the debtor licensor, Richmond Metal, granted a nonexclusive license to Lubrizol to use a metal coating process.[9] Richmond Metal sought to reject the license agreement as an executory contract with the intention to sell or license the technology to others.[10] The Fourth Circuit sustained the exercise of business judgment to reject the contract as executory, emphasizing the reciprocal duties of keeping the licenses up to date and protecting its use while the licensee was obligated to account for royalties.[11] In the end, the court permitted the debtor licensor to reject its technology license agreement with Lubrizol.[12] The court made this allowance despite the fact that rejection would seriously burden Lubrizol financially.[13] Arguably, the result of such rejection was that a nonbankrupt licensee, who may have premised an entire

[7] 11 U.S.C. § 365 (2004).
[8] *Lubrizol Enters, Inc. v. Richmond Metal Finishers, Inc*. 756 F.2d 1043 (4th Cir. 1985).
[9] *Id*. at 1045.
[10] *Id*.
[11] *Id*. at 1046.
[12] *Id.* at 1048.
[13] *Id*.

business around the use of the licensed technology, could lose all rights to the licensed technology.

In response, industry lobbyists implemented efforts in Congress to overturn this decision. The licensing community believed that it was powerless when confronted with licensor bankruptcy proceedings since they were forced to either retain the benefit of its bargains or recoup its investment costs. What cumulated as a result of their efforts was the Intellectual Property Licenses in Bankruptcy Act of 1988.[14] Specifically 11 U.S.C. 365(n) was adopted in an attempt to protect a licensee's rights in the use of intellectual property despite rejection of the executory licensing agreement in bankruptcy. In addition, Congress saw fit to head off any arguments as to the definition of "intellectual property" thus prompting them to include a list of what was to be included in the definition.[15]

In general, section 365 of the Bankruptcy Code describes the substantive rights, and limits, of a debtor with respect to contractual relationships established prior to any bankruptcy petition. These rights include the right of a debtor to "assume" an executory contract and then to assign or sell the contract to a third party. Arguably, one of the goals of section 365 is free assignability by permitting assignments of licenses sometimes without regard to contract provisions or state law that would otherwise prohibit assignment outside the penumbra of bankruptcy.

More specifically, section 365 of the Bankruptcy Code authorizes the trustee to assume or reject executory contracts and unexpired leases. A trustee or debtor-in-possession[16] must obtain the court's approval in order to assume or reject a contract.[17] Typically, deference is given to a trustee's decision with a court only concerned with

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[14] See William D. Warren and Daniel J. Bussel, Bankruptcy 260 (Sixth Ed., Foundation Press 2002).

[15] "Intellectual Property" includes the following "to the extent protected by applicable nonbankruptcy law":

1. Trade secrets
2. Invention, process, design, or plant protected under title 35
3. Patent application
4. Plant variety
5. Work of authorship protected under title 17
6. Mask work protected under chapter 9 of title 17. See 11 U.S.C. § 101(35A) (2004). Trademarks and trade name rights are not included in this section.

[16] A debtor-in-possession is a Chapter 11 or 12 debtor that continues to operate its business as a fiduciary to the bankruptcy estate. BLACK'S LAW DICTIONARY 177 (2nd Pocket ed. 2001).

[17] 11. U.S.C. §365 (a) (2004).

decisions made in bad faith or in abuse of discretion.[18] A trustee will typically base the decision on the costs involved in taking over the debtor's obligations and whether these costs exceed the value of the nondebtor's remaining performance.

If a trustee rejects an executory contract under which the debtor is a licensor of a right to intellectual property, and the rejection amounts to such a breach that the licensee would be entitled to treat the contract as terminated by virtue of its own terms, Section 365(n) gives the licensee the right to elect to treat the contract as terminated.[19] Alternatively, upon rejection by a licensor in bankruptcy, a licensee may elect to retain during the period of the licensing agreement and any extension thereof to which the licensee has a right.[20] For a licensor, Section 365(n) is of utmost importance because it outlines the protections offered to licensees of intellectual property in the event the licensor files for bankruptcy. Section 365(n) is not often applicable to a nonprofit due to the fact nonprofits, such as universities, are not likely candidates for bankruptcy. What lends itself to interpretation, however, are the rights of a nonprofit licensor when the licensee files for bankruptcy. This issue will be addressed below.

C. Exclusive Licenses, Nonexclusive Licenses, and Assignment under the Bankruptcy Code

A key issue that must be addressed prior to any bankruptcy proceeding is the classification of the prior agreement as an exclusive license, a nonexclusive license or an assignment. Bankruptcy issues rarely arise in connection with a debtor's ownership of patent rights pursuant to an exclusive patent license or outright patent assignment. Because the assignee under an outright assignment or exclusive license may exclude others, the assignee does not need to assume the right due to the fact the assignee already owns the rights to the technology.[21] The seminal bankruptcy case that discussed whether a transfer of patent rights was an assignment or a license is *In re Access Beyond Tech.,*

[18] *In re Minges*, 602 F.2d 38 (2d Cir. 1979).
[19] See 11 U.S.C. § 365 (n)(1) (2004).
[20] *See id.* § 365 (n)(1).
[21] See *In re Access Beyond Tech., Inc.* 237 B.R. 32, 34 (Bankr. D. Del 1999).

Inc.[22] The court held, as a matter of law, any nonexclusive grant of the right to make, use, or sell a patented invention "by its very terms, is not an assignment, but a naked license."[23] The implication of this decision was that debtor licensees may seek to have a license contain explicit language so as to classify it as an executory contract so that assumption and assignment might be limited by section 365 of the Bankruptcy Code. It is important to note, however, that the label given to a contractual arrangement is not dispositive. Courts will look to the true nature and economic reality of the contractual relationship.

D. Executory Contracts

Although section 365 explicitly deals with executory contracts, the drafters of this section failed to define the term "executory contract." Both the legislative history and case law alike have adopted the "Countryman" definition named after the famed Professor Vern Countryman of Harvard University.[24] Under Countryman's definition, an "executory contract" is "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other."[25] Countryman's definition requires performance on both sides because it benefits the bankruptcy estate. This definition, however, is based on the premise that assumption does not benefit the estate and would convert the debtor's obligation into an administrative expense. It is also important to note that according to Countryman, a contract cannot be executory if either the debtor or nondebtor party to the contract has fully performed. Today, there is a growing movement to remove the executory requirement but a vast majority of courts still adhere to this definition.

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[22] "An agreement is a sale of patent rights only if it conveys: (1) the whole patent, comprising the exclusive right to make, use and sell the invention; (2) an undivided share of that exclusive right; (3) an exclusive right to practice the invention within a specified territory... Unless the writing conveys some or all of the right to exclude others from practicing the invention, it will not convey an interest in the patent, but a mere license." *Id*. at 49.
[23] *Id.* at 44.
[24] H.R. Rep. No. 595, 95th Cong., 1st Sess. 347 (1977); *RCI Tech. Corp. v. Sunterra Corp*. 361 F.3d 257, 264 (4th Cir. 2004).
[25] Vern Countryman, *Executory Contracts in Bankruptcy*, 57 Minn. L. Rev. 439, 446 (1973).

E. Case Law "Tests"

The significant number of start-up technology companies filing for bankruptcy has already led to a myriad of section 365 decisions over the years. The interpretation of section 365 and its applicability to intellectual property licensing varies by jurisdiction. The difference in opinions has centered on the diverging interpretations as to how to reconcile the notion of free assignability, articulated in section 365(f),[26] with the notion of limited assignability found in section 365(c).[27] At the center of this contention is the use of the phrase "applicable law" which has confused judges and lawyers alike. The Sixth Circuit, in its decision in *In re Magness,* squarely addressed the issue of whether the seemingly warring provisions of section 365(c)(1) and section 365(f)(1) are reconcilable.[28] The court acknowledged that section 365(c) appears to be a recognized exception to 365(f) that gives the illusion of reviving, in full, the very anti-assignment "applicable law"" which 365(f) nullifies.[29] The court also noted that the conflict between section 365(c)(1) and section 365(f)(1) is illusory, because "each subsection recognizes an 'applicable law' of markedly different scope."[30]

Today, a split among the courts exists as to whether the transferability of a patent license is a question to be determined by application of state law or one determined by application of federal law. Some courts adhere to the notion that the applicable law is a body of non-statutory, "federal common law" which holds that patent and copyright

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[26] "Except as provided in subsection (c), notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease under paragraph (2) of this subsection...." 11 U.S.C. § 365 (f)(1) (2004).

[27] "The trustee may not assume or assign an executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if--

(1)(A) applicable law excuses a party, other than the debtor, to such contract from accepting performance from or rendering performance to an entity other than the debtor or the debtor-in-possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and

(B) such party does not consent to such assumption or assignment..." 11 U.S.C. § 365 (c) (2004).

Section 365(f) states that a contract may be assigned "notwithstanding. . . applicable law, that prohibits. . . assignment." 11. U.S.C. § 365 (f) (2004).

[28] *In re Magness,* 972 F.2d 689, 695 (6th Cir.1992).

[29] *Id*.

[30] *Id*.

licenses are non-assignable without the consent of the patent or copyright owner.[31] Other courts firmly base their decisions on the bankruptcy policy of promoting free assignability of contracts and the maximization of a debtor's bankruptcy estate.[32] For the nonprofit licensor, the answer to this inquiry is extremely important due to the potential loss of control of the license's fate at the hands of the licensor or bankruptcy trustee.

(i) Hypothetical Test

Courts adopting the "hypothetical test" have interpreted section 365(c) to mean that if a debtor cannot assign an executory contract then it cannot assume the contract. If a debtor cannot "assume" a technology license, then the patent owner may argue that the license terminates as a matter of law under standard "ipso facto" clauses which make bankruptcy an event of default. Ipso facto or termination clauses are extremely common and provide that a contract is terminated upon the bankruptcy of a party to the contract. Critics of the hypothetical test believe the forfeiture of the debtor's legal rights against the nondebtor is inconsistent with current bankruptcy policy as illustrated through the general rule that termination clauses are invalid in bankruptcy. A majority of non-bankruptcy courts have adopted the "hypothetical test."[33]

The beginnings of the hypothetical test began in the Ninth Circuit with *In re CFLC, Inc*.[34] In this case, Cadtrak, in return for a lump-sum one-time payment of $200,000, granted CFLC a royalty-free, worldwide, exclusive license to certain computer related technology.[35] The language of the license agreement indicated it was non-transferable, could be terminated upon bankruptcy, and was subject to California law.[36] During the impending Chapter 11 proceeding, Cadtrak objected to the assumption and assignment of its license by CFLC.[37] The court held that federal law governed the assignability of

[31] *In re Catapult Entm't, Inc.,* 165 F.3d 747, 748 (9th Cir. 1999).
[32] *See Cinicola v. Scharffenberger,* 248 F.3d 110, 220 (3d Cir. 2001) (stating "generally, the Bankruptcy Code . . . allows a trustee to assume and assign executory contracts regardless of applicable laws or contractual provisions restricting assignment").
[33] *See e.g., In re CFLC, Inc*., 89 F.3d 673, 676-77 (9th Cir. 1996).
[34] *Id*.
[35] *Id*. at 674.
[36] *Id*.
[37] *Id*.

nonexclusive patent licenses and because federal law makes licenses personal and assignable only with the consent of the licensor, such a license was not assumable and assignable in bankruptcy.[38]

In another "hypothetical test" case, *In re Catapult*, the Ninth Circuit faced the issue of whether a Chapter 11 debtor may assume certain nonexclusive patent licenses over the licensor's objection.[39] Factually, Catapult entered into two patent license agreements with Perlman.[40] Catapult then proceeded to enter into a merger agreement with Mpath Interactive, Inc. leaving Catapult as a surviving entity.[41] Catapult filed for Chapter 11 reorganization and filed a motion to assume a number of executory contracts and leases including the two patent licenses with Perlman.[42] The bankruptcy court granted Catapult's motion and the district court affirmed.[43]

The *Catapult* court was quick to note that there was an obvious divergence in opinions as to the interpretation of 365(c)(1) which contemplates the requirement of a nondebtor's consent for a trustee to assume or assign any executory contract.[44] The court also articulated the "hypothetical test" to mean that a debtor-in-possession may not assume an executory contract over the nondebtor's objection if applicable law would bar assignment to a hypothetical third party, even where the debtor-in-possession has no intention of assigning the contract in question to any such third party.[45] To begin its analysis the court construed the meaning of the statutory language to mean that by its terms, a debtor-in-possession may not assume any executory contract without the nondebtor's consent where applicable law precludes assignment of the contract to a third party.[46] The court even went so far as to substitute the facts of the case directly into the statutory language of Section 365(c)(1) to conclude that Catapult could not assume the Perlman licenses if federal patent law excuses Perlman from accepting performance from or rendering performance to an entity other than Catapult, and Perlman does not consent

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[38] *Id*. at 678.
[39] *In re Catapult Entm't, Inc.,* 165 F.3d 747, 748 (9th Cir. 1999).
[40] *Id*.
[41] *Id.* at 749.
[42] *Id*.
[43] *Id*.
[44] *Id*.
[45] *Id.* at 750.
[46] *Id*.

to such assumption.[47] It is important to note that the *Catapult* court did not hesitate to point out that the treatment of "applicable law" varied by jurisdiction.[48] The *Catapult* court, however, held firm in its belief that a literal reading of subsection (c)(1) and (f)(1) were, in fact, not at odds with each other.[49] Upon this premise, the Ninth Circuit held that without the consent of the licensor under a nonexclusive license of a patent, a debtor-licensee could neither assume nor assign that license under Section 365.[50]

The "hypothetical test" as articulated by the *Catapult* court is still alive today. In March 2004, the Fourth Circuit applied this plain meaning approach to a copyright license between Sunterra, a major resort management company, and RCI, a software development company for the resort and hospitality industry.[51] In 1997, RCI and Sunterra entered into a software licensing agreement allowing Sunterra to use an RCI copyrighted computer program and modify the program for Sunterra's timeshare swapping system. Sunterra received a nonexclusive, royalty-free license to use, copy, modify, and distribute the software, including use of this software to develop its own software system.[52] Additionally, Sunterra would be the owner of any enhancements it developed, and in turn, Sunterra granted RCI a license to use the Sunterra enhancements.[53] Approximately three years after entering the license agreement, Sunterra filed for Chapter 11 bankruptcy.[54]

In the final hours before reorganization confirmation, RCI filed a motion with the bankruptcy seeking a declaration that the license be rejected because federal law prohibited assignment of nonexclusive copyright licenses without the consent of the licensor.[55] The bankruptcy court denied the motion claiming the license was not an executory contract and 365(c)(1) did not preclude assumption because Sunterra did not intend to assign the license.[56] On appeal, the district court reversed the bankruptcy court's characterization of the license, holding that the license was, in fact, an executory

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[47] *Id*.
[48] *Id.* at 752.
[49] *Id*.
[50] *Id*. at 747.
[51] *In re Sunterra Corp*. 361 F.3d 257, 260 (4th Cir. 2004).
[52] *Id.*
[53] *Id*. at 261.
[54] *Id*.
[55] *Id*.
[56] *Id*.

contract, subject to assumption or rejection under section 365.[57] The district court did, however, affirm the bankruptcy court, adopting the "actual test" for construction of 365(c)(1) as applied to assumption of an executory contract by a Chapter 11 debtor-in-possession.[58] On appeal, the Fourth Circuit reversed the bankruptcy court and adopted the "hypothetical test" based on a literal reading of 365(c)(1) on its way to conclude that not only was the copyright license "executory," but consent was required for assumption.[59]

In addition to raising awareness of the divergence in opinions concerning section 365, another lesson for nonprofit's to learn from the Sunterra case is that some courts will not view assignment to be equal to assumption. A provision of the license at issue in *Sunterra* provided that the assignment section of the license shall not preclude the transfer of the license to a successor in interest of substantially all of Sunterra's assets if the assignee agrees in writing to be bound by the license.[60] Sunterra maintained that RCI had consented to permit transfer of the license.[61] RCI argued that any consent it provided to Sunterra in the license is irrelevant because, under the statute, the issue is whether applicable law prohibited the transfer irrespective of the provisions of the license.[62] The court held that this provision of the license at issue pertains to an assignment rather than an assumption so without RCI's consent, Sunterra was precluded from assuming the license.[63]

(ii) Actual Test

Courts adhering to the "actual test" reason that a debtor can assume its own pre-petition contracts, even if non-assignable, as long as the debtor does not intend to actually assign the contract to a third party.[64] Under the actual test, where the debtor-in-possession, rather than the trustee, assumes the license, the licensor receives performance

[57] *Id*. at 262.
[58] *Id*.
[59] *Id*. at 271.
[60] *Id.* at 270.
[61] *Id*. at 271.
[62] *Id*.
[63] *Id*.
[64] *In re Neuhoff Farms, Inc.,* 258 B.R. 343, 350 (Bankr. E.D.N.C. 2000).

from the party with whom it originally contracted, and the debtor-in-possession could assume the contract. The actual test is followed by a majority of bankruptcy courts and requires the court to conduct a "case-by-case inquiry into whether the nondebtor is forced to accept performance under its executory contract from someone other than the debtor party with whom it actually contracted."[65] Firm believers in the "hypothetical test" may argue the actual test to be an over-step of authority in that it adds a new dimension of allowing assumption but not assignment.

The First Circuit has been instrumental in developing the actual test. The test saw its meager beginnings in *Summit Invest. Corp. v. Leroux*.[66] In this case, a group of partners entered into an agreement whereby in the event a general partner filed for bankruptcy, the bankrupt partner's interest would be converted to the partnership divesting the bankrupt partner of the right to participate in management activities.[67] Two of the three partners filed Chapter 11 petitions but continued their positions in the partnership.[68] The remaining solvent creditor, Summit, then initiated proceedings seeking a declaration that the bankrupt partner's interests terminated under the *ipso facto* provisions of the partnership agreement.[69]

In its opinion, the First Circuit was quick to point out both the plain meaning and legislative history behind section 365.[70] In considering the termination clause, the court noted that the legislative history indicated that an "automatic termination of a debtor's contractual rights 'frequently hampers rehabilitation efforts' by depriving the chapter 11 estate of valuable property interests at the very time the debtor and the estate need them most."[71] The court also explicitly rejected the appellant's proposed "hypothetical test" by considering the legislative history of section 365.[72] The court believed that Congress instead envisioned a case-by-case inquiry into the actual consequences to the nondebtor

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[65] *Institut Pasteur v. Cambridge Biotech. Corp*., 104 F.3d 489, 493 (1st Cir. 1997), cert. denied, 521 U.S. 1120 (1997).
[66] *See Summit Inv. Corp. v. Leroux*, 69 F.3d 608 (1st Cir. 1995).
[67] *Id.* at 609.
[68] *Id*.
[69] *Id*.
[70] *Id*. at 610.
[71] *Id*. *See* S.Rep. No. 989, 95th Cong., 2d Sess. 59 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5845.
[72] *See Summit* 69 F.3d at 613.

party in the event the executory contract was performed by the debtor in bankruptcy.[73] Thus the foundation of the "actual test" was laid and the battle of the circuit courts began.

Two years later, the First Circuit once again pressed ahead with its belief in the "actual test."[74] In *Institut Pasteur v. Cambridge Biotech. Corp.*, Pasteur, the licensor, appealed a bankruptcy court decision to allow Cambridge Biotech Corporation (CBC) to continue to utilize two licenses.[75] The reorganization plan allowed the sale of all CBC stock to a competitor of Pasteur.[76] Pasteur argued that 365(c) prohibited CBC's assumption of the patent cross-licenses and that de facto "assignment" to a third party contravened the presumption of nonassignability ordained by the federal common law of patents.[77] The First Circuit expressly rejected the hypothetical test and held that the licensor could not terminate the agreement.[78] The court reasoned that the licensor could have anticipated that the debtor-licensee might experience a change in stock ownership and therefore had an opportunity to preclude the transfer of stock to a named competitor.[79] Additionally, the court noted that Pasteur could have contracted for restrictions in the event that there were changes in stock ownership or corporate control.[80] Consequently, the court allowed CBC to assume the patent cross-licenses, and Pasteur was forced to license its patent to a major competitor because CBC was acquired as part of the reorganization plan.[81]

For a nonprofit licensor, the actual test approach may cause a few headaches. One problem is the potential loss of control over the license if precautionary measures are not taken. Another problem that might arise is the fact the technology may wind up in the hands of a company who is in direct competition with a current corporate research sponsor resulting in tension between the nonprofit and a sponsor. Finally, in the event the technology was funded by the federal government, Bayh-Dole implications may result in problems for both the new assignee and nonprofit.

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[73] *Id*.
[74] See *Institut Pasteur v. Cambridge Biotech. Corp*., 104 F.3d 489 (1st Cir. 1997), cert. denied, 521 U.S. 1120 (1997).
[75] *Id*. at 490-491.
[76] *Id*. at 490.
[77] *Id*. at 491.
[78] *Id*. at 492-493.
[79] *Id.* at 494.
[80] *Id.*
[81] *Id*.

III. Proposed Nonprofit Strategies to Licensing

Based on the foregoing discussion of the divergence among the courts in construing the rights of the licensor and licensee in bankruptcy, it goes without saying that a minefield exists for nonprofit licensing professionals. Due to the preference for start-up company licensing under Bayh-Dole, bankruptcy issues have been and will continue to be an important issue for the nonprofit licensor. Many of the pitfalls, however, may be avoided by constructing a license that takes into consideration the repercussions of both assignment and assumption along with the provisions that either create or restrain each. This means a number of precautionary measures should be taken. These measures are discussed below.

1. License as a Personal Contract

Nonexclusive license agreements are generally held to be personal.[82] State statutes often reflect a policy in favor of the free transferability of all types of property including rights under contracts. That is, the duties imposed upon one party may be of such a personal nature that their performance by someone else would, in effect, deprive the other party of that for which he bargained. In addition, some federal courts have noted that nonexclusive license agreements are generally held to be personal and nonassignable. Also, the terms of a contract may show an intent to be nonassignable. The result is duties and rights cannot be assigned if the assignment would materially impair the nonassigning party's chance of obtaining the expected performance.

Regardless of the law of the controlling jurisdiction, a nonprofit should make sure their intentions as to assignability are explicitly expressed within the license. If the nonprofit so chooses, the license terms should be constructed so that the contract clearly appears "personal" in nature thus improving the licensor's chances of retaining control over the fate of the license should bankruptcy occur.

[82] *See e.g., In re CFLC, Inc.*, 89 F.3d 673, 678 (9th Cir. 1996).

2. Security Interests

A nonprofit licensor may also want to consider taking a security interest in the license. Generally speaking, a licensor or a third party may have a security interest in the licensee's rights to secure the licensee's payment obligations in addition to a right to terminate a licensee's rights before a bankruptcy petition is filed if certain conditions are not met. Having a security interest may allow the nonprofit licensor to be in a better position to buy back the license and deduct the unpaid royalties from the purchase price.

At this juncture, it is important to discuss a twist to Article 9 that nonprofit licensors need to consider. Sometimes, a creditor of a licensee may perfect a security interest in the rights under the license from the nonprofit licensor. The secured creditor's right to enforce its security interest is outlined in section 408 of Article 9. Under this section, a term in the license prohibiting assignment and providing for a default upon an attempted assignment is ineffective to prevent the creation, attachment, or perfection of the security interest.[83] Luckily for a nonprofit licensor, nothing in section 9-408 prevents the licensor from providing that the secured party's enforcement efforts trigger a default under the license. Nonprofit licensing professionals should, however, note that pre-petition termination of an executory contract that has value to the bankruptcy estate might constitute a voidable transfer or fraudulent conveyance.[84] Therefore, a careful survey of case law in the binding jurisdiction and a working knowledge of the Uniform Fraudulent Conveyance and Fraudulent Transfers Acts will be in order.

3. Non-assignability Clause

When working with a licensee of questionable long-term solvency, the licensor would be well advised to take a few precautions. The nonprofit licensor should include explicit language in the license to make it clear to the licensing party that the licensor considers the license to be personal and nonassignable. As mentioned earlier, the Ninth Circuit hold fast to the idea that the licensor determines the destiny of the license in terms

[83] See U.C.C. § 9-408 (2002).
[84] See, e.g., *In re Edward Harvey Co., Inc*., 68 B.R. 851 (Bankr. D. Mass. 1987).

of assignabililty. Some courts have even gone so far as to classify contracts in which the debtor is a licensee of a patent as "inherently unassignable" under federal common law in the absence of the licensor's consent.[85] It is important, however, that the licensor not be lulled into a false sense of security in terms of control of the assignability of the license in bankruptcy. As one can see from the case law discussion above, the opinions as to assignability control are anything but settled. Therefore, implementing a non-assignability clause should be included so that whatever control might be in existence may be harnessed.

Alternatively, the license may contain a provision awarding conditional assignment rights giving a limited right to assign the license to subsidiaries or other affiliates at the discretion of the nonprofit licensor. This might show that the nonprofit licensor is willing to be flexible in considering assignment and in the end, might allow the licensor to circumvent a cessation in royalties.

4. Examine and Monitor Licensor's Financial Health

Nonprofit licensing professionals need to be aware that 365(e) invalidates clauses which automatically terminate an executory contract or permit the other party to terminate, in the event of bankruptcy (ipso facto clauses).[86] Therefore it is extremely important that the nonprofit licensor take measures to implement certain "triggers" in the license by which certain, established events give the licensor the power to decide the fate of the license prior to a bankruptcy petition.

As a preliminary matter, a nonprofit licensor will want to examine a licensee's financial well-being prior to any agreement. One strict approach might be to make the licensee's solvency a condition for entering into the license in the first place. Since most start-up companies are not likely to be solvent, this option may not be readily available. Therefore, a nonprofit licensor should take the normal steps of requiring a solid business plan, competent management, and a steady stream of outside financing (venture capital, angels, etc) prior to licensing.

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[85] *In re Alltech Plastics, Inc*., 71 B.R. 686, 689 (W.D. Tenn. 1987).
[86] See 11 U.S.C. § 365 (e)(1) (2004).

In addition to the preliminary requirements to reaching an agreement, the nonprofit should be sure to include specific performance criteria in the license, such as royalty accounting and financial condition covenants. The license should provide that the failure to meet any one of these criteria results in immediate, automatic license termination. No time to repair or cure financial ailments should be permitted. A cure period may allow time for a bankruptcy petition to be filed resulting in the nonprofit licensor being locked out by an automatic stay.

5. Thinking Outside the Automatic Stay

An automatic stay bars anyone from taking action to recover a debt then owing by the debtor or acting to affect property of the debtor or the estate. The stay maintains the status quo and prevents dismemberment of the estate by individual action of creditors and others. The impact of this stay is quite significant for a nonprofit licensor in that it's power to terminate the license is temporarily suspended. This leaves the licensor at the apparent mercy of the bankruptcy trustee unless arrangements can be made. In addition, the stay may cut off all royalty payments putting a nonprofit, such as a university, in a position of having valuable technology not being used to serve society as per Bayh-Dole.

A university technology manager or advising attorney facing this dilemma is not completely without recourse. As discussed above, there are a number of options that may arise at this point. Each is dictated by the goals and flexibility of the bankruptcy trustee. One option that might pan out under the bankruptcy code is for the trustee to allow the licensee to continue to utilize and make royalty payments on the technology. Considering the licensee is in the midst of bankruptcy proceedings, this may not be the best option. Another option is for the trustee to assume and perform under the license. This is highly unlikely to happen due to the nature of the technology.

A final option upon the implementation of a stay is to negotiate the forgiveness of any debt owed to the nonprofit in exchange for a termination of the license. This is a very serious decision on behalf of the nonprofit. Before seeking this arrangement, technology transfer professionals should contemplate the amount of outstanding debt to be forgiven in light of the opportunity to license the technology to another company and

the possibility of march-in rights that might develop as a result of non-compliance with the goals of Bayh-Dole.

IV. Conclusion

Licensing, for a nonprofit, can be a high stakes game in view of the existing tensions between the policies of bankruptcy and intellectual property law. What is obviously needed is for the Supreme Court to propose a resolution of the split in the circuits regarding the non-assumability of inherently non-assignable contracts.
As an alternative, appropriate legislation may be implemented to provide a resolution among the above-mentioned subsections of section 365. One solution might be to allow a debtor-in-possession to assume a nonexclusive license, but restrict assignment unless allowed for in the licensing agreement. In theory, this would allow a debtor-in-possession to continue reorganization by retaining its licensed, foundational intellectual property rights. It might also serve to protect the rights and royalty income of the licensor by restricting assignment. In this way, the licensor would not be forced to accept performance from an unintended third party. For the nonprofit licensor, the downside to this solution is the possibility of a loss of royalty income but this risk may be outweighed by the licensor's ability to retain control over assignment. Therefore, until harmony is attained among the circuits, a nonprofit licensor should take the proper precautionary measures outlined above while staying apprised of changes in the statutory and case law.