SELECTED TRICKS AND TRAPS IN SALES OF INTELLECTUAL PROPERTY IN CROSS-BORDER INSOLVENCY CASES

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I. Summary of Selected Issues Raised by a Hypothetical Sale of the Assets of a Software Company in Both a "Foreign Main Proceeding" and a U.S. Chapter 15 Case

The distressed foreign software company in the III program hypothetical case study[1] confronts at least the following issues and alternatives in liquidating its intellectual property. As explained in more detail below in this article, other issues predictably also will arise.

A. Allocations Between U.S. and Foreign Main Proceeding.

In the typical scenario, the "foreign representative" from a "foreign main proceeding" can be expected to use Chapter 15 of the U.S. Bankruptcy Code to enhance the overall proceeds from the sale of assets of the debtor's estate.[2] This enhancement can be accomplished in sale transactions by employing certain strategies in each of the two proceedings. In many cases, this approach will mean requesting the U.S. Chapter 15 court to allow the foreign representative to exercise powers that the trustee in bankruptcy typically has in U.S. Chapter 11 cases pursuant to §§ 1521(a)(7) and 1520(a)(2) and (3). The U.S. Bankruptcy Code allows for the efficient sale of assets and assignment of contracts, as well as various related powers to enhance the buyer's benefit of its bargain, such as by persuading the selling foreign representative to reject certain executory contract obligations and sell the assets free and clear of certain liens, interests, and (in certain circuits) claims.

Certain contractual provisions that otherwise would obstruct such foreign representative's powers are negated by the Bankruptcy Code. For example, § 365(e)(1) generally invalidates provisions of such contracts that would allow termination or modification of the contracts based upon "*ipso facto*" provisions relating to bankruptcy, insolvency, adverse financial condition, or other specified circumstances. The ability to ignore *ipso facto* clauses is a substantial advantage for the foreign representative that is not always clearly available in other forums. However, certain exceptions to the statutory override of *ipso facto* clauses exist, and there is a debate among various U.S. Circuit Courts as to whether such exceptions (*e.g.*, §§365(e)(2) and 365(c)) apply only in the case of actual assignments to third parties (the "actual test") or under the "hypothetical test" even without an actual assignment.[3]

The way in which the *ipso facto* provision of the Bankruptcy Code and related exceptions apply in foreign main proceedings, or in contracts with U.S. counterparties in which foreign law governs, is a complex issue, illustrated later in this article. It is important to note here that the

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[1] This is one of a series of related articles for the International Insolvency Institute's Seventh Annual Conference on June 12, 2007. However, this article attempts to present the data in a way that also can provide useful information beyond the III hypothetical.

[2] Unless otherwise stated, terms used in this article shall have the same meaning as defined in Chapter 15, Title 11 of the United States Code (the "Bankruptcy Code"). Chapter 15 is the U.S. version of the UNCITRAL Model Law on Cross-Border Insolvency. The differences between Chapter 15 and the Model Law are modest.

[3] *See, e.g.*, *In re Mirant*, 440 F.3d. 238 (5th Cir. 2006) (the more recent case in a series of decisions debating these issues, adopting the "actual test") and *Summit Inv. & Dev. Corp. v. Leroux*, 69 F.3d 608 (1st Cir. 1995). The hypothetical approach is illustrated in *In re West Elecs. Inc.*, 852 F.2d 79 (3d Cir. 1988) and in decisions in the Fourth, Ninth, and Eleventh Circuits. *See also In re Catapult*, 165 F.3d 747 (9th Cir. 1999); *In re James Cable Partners, L.P.*, 27 F.3d 543 (11th Cir. 1994).

foreign main proceeding may be able to clarify such issues for the U.S. Chapter 15 court, so that the remainder of the U.S. sale and related transaction processes can proceed in reliance on principles of comity to answer questions about the applicable nonbankruptcy law. Absent a reason in other applicable foreign jurisdictions not to enforce the *ipso facto* rule, the general U.S. *ipso facto* rule can prevail.

B. <u>Foreign Representatives Can Use Chapter 15 to Conduct Effectively Sale-Related Transactions</u>.

As explained below, the foreign representative of the hypothetical software company will seek to obtain the rights in the Chapter 15 case under §§ 1520(a)(2) and (3) and 1521(a)(7), to conduct the same kind of contract resolution and asset sale processes that a trustee in bankruptcy typically would conduct in a U.S. Chapter 11 case, relying on §§ 363(f), 365, and other rights accorded by the U.S. Bankruptcy Code, including:

1. Selling the U.S. assets, including the trade secrets, patents, copyrights, and trademarks (together with associated goodwill) owned by the debtor free and clear of liens, interests, and (in certain circuits, where allowed) claims pursuant to § 363(f). Note that appellate challenges to such sales can be deemed "moot" under § 363(m) where the court makes an appropriate "good faith" finding;

2. Assuming and assigning the licenses and other contracts that the IP buyer desires and that are subject to U.S. jurisdiction under Chapter 15,[4] curing defaults (to the extent that they must be cured for such purpose) and providing adequate assurances of future performance. *See* § 365(b) and illustrations later in this article as to what may need to be "cured." Typically, the software company's IP licenses and other contracts can be assigned under § 365(f), despite the existence of anti-assignment clauses in the contracts, *except* as to licenses where the debtor software company is a licensee of a *nonassignable* U.S. patent, trademark, copyright, or mask-work license, or where "personal services" or other exceptions apply.[5] Complex questions arise as to the impact of the choice of non-U.S. law in a contract with respect to whether a contract is assignable or not assignable under § 365(c)(1).[6] Some U.S.

[4] This power arguably includes more than merely contracts involving U.S. choice-of-law and -forum provisions. While there is currently little case law on point, many expect Chapter 15 jurisdiction to extend to contracts between the debtor and U.S. counterparties, even if foreign law is chosen to govern in the contract and, perhaps, even if a foreign forum is stipulated. For example, if the contract is to be rejected in the Chapter 15 case, some of the forum-selection/venue provisions can be argued to be terminated, depending on the wording and structure of the contract. Covenants are executory and vulnerable to rejection under § 365, although grants arguably are not. Thus, a mere promise not to challenge venue may be vulnerable to being rejected as an executory obligation. The fact that a counterparty is in the U.S. may be sufficient for such an argument to be heard. The new legal specialty of "bankruptcy-proofing" cross-border IP transactions focuses on *grants* that are less vulnerable to challenge, such as submissions to jurisdiction. However, the debate is whether a submission to *exclusive* jurisdiction is merely a promise not to use an alternative jurisdiction that may be available.

[5] Section 365(f) allows assignment of many U.S. contracts that are nonassignable by their terms, such as real estate leases. Section 365(c)(1) limits that right of assignment by its reference to "applicable law" excusing the nondebtor party from having to accept a replacement, such as in personal service contracts and certain federal IP contracts. *See* note 3, *infra*.

[6] This topic is too complex to be addressed fully in this article. However, it should be noted that, if the court in the foreign main proceeding rules on the question of relevant assignability factors, that decision may provide a means

courts have noted that exclusive copyright licenses are assignable as *de-facto* sales; others have attempted to extend that reasoning to create, mistakenly, a general rule for assignability of exclusive IP licenses and nonassignability of nonexclusive IP licenses;[7]

3. Rejecting any further obligations under the U.S. licenses and other contracts that the IP buyer does *not* want or expressly wants to terminate. For example, the buyer of a patent may want the foreign representative to reject the patent licenses to third-party licensees, so that the buyer can sue the licensees for infringement unless the licensees negotiate a new license satisfactory to the buyer. In situations where the software company debtor is a licensor rejecting an IP license, the nondebtor licensee may have a right to elect to retain certain rights under § 365(n). However, as discussed below, § 365(n) is of limited effect, in that it does not apply at all to trademark licenses and does not protect licensees with respect to foreign patents and copyrights.[8] Moreover, the § 365(n) license retention election is expensive, because it requires full payment of all future royalties with no offset allowed to account for the fact that the debtor will be providing no further performance under the contract beyond forbearance from suing the former licensee for infringement or what is protected by § 365(n). Many flaws and ambiguities in § 365(n) are being exposed in increasing litigation in U.S. bankruptcy cases, which is good news for foreign representative IP sellers.[9] Furthermore, some read the *Precision Industries* case as permitting the § 363(f) sale to strip away the right to make a § 365(n) election, although no reported decision has done so, and many would regard that kind of controversial ruling as incorrect;[10] and

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for supporting such assumption and assignment in the Chapter 15 case by eliminating through comity/res judicata or collateral estoppel, the nondebtor party's arguments under § 365(c)(1). *See* note 3, *supra*.

[7] The question of what cannot be assigned by licensees (without licensor consent) under § 365(c)(1) is one of federal IP law. In cross-border cases, the foreign main proceeding may speak to this more complex choice-of-law issue, and thereby help resolve the question in the U.S. in terms of free assignability under § 365(f). Some courts and commentators make much of the distinction between "exclusive" and "nonexclusive" licenses, but they engage fundamentally in a discussion about what is "executory" (*e.g.*, a covenant not to sue) and what has been executed (*e.g.*, a copyright sale via an exclusive license, as in *In re Independent Serv. Orgs. Antitrust Litig.*, 203 F.3d 1322 (Fed. Cir. 2000)). *See, e.g., In re Golden Books Family Entertainment, Inc.*, 269 B.R. 300 (Bankr. Del. 2001). Some bankruptcy courts have mistakenly assumed that the rules for assignment under patent and trademark law are the same as they are under copyright law. Extending such overriding assignments in the absence of licensor consent beyond exclusive copyrights is a common mistake. Indeed, what often are labeled "exclusive" patent and trademark licenses actually are merely exclusive in particular fields of use or territories.

[8] The definition of "intellectual property" in 11 U.S.C. § 101(35A) refers to (A) trade secrets, (B) "invention, process, design or plant protected under Title 35," (C) "patent application," (D) "plant variety," (E) "work of authorship protected under Title 17," or (F) "mask work protected under Chapter 9 or Title 17," in each case in (A)-(F), "to the extent protected by applicable nonbankruptcy law."

[9] For example, what "supplementary agreements" associated with the license are entitled to § 365(n) protection? Other than with respect to software escrows and confidentiality agreements, there is little consensus.

[10] Just as IP licensees rejected by licensors in bankruptcy have § 365(n) protection, tenants have similar rights under § 365(h) in their landlord's bankruptcy. In *Precision Indus., Inc. v. Qualitech Steel SBQ, LLC (In re Precision Indus., Inc.)*, 327 F.3d 537 (7th Cir. 2003), the court permitted the debtor selling its assets under § 363(f) to sell free and clear of the § 365(h) right. Some bankruptcy lawyers urge the same result for IP licenses in IP sales under § 363(f)—*i.e.*, stripping § 365(n) rights. There are many technical and policy arguments as to why that controversial theory should fail, which may explain why no reported decision has held that the § 365(n) right can be destroyed in such a § 363(f) sale.

4. Exercising rights in the Chapter 15 case to dispute and limit the claims of the U.S. parties against both the buyer and the debtor's estate, including by using U.S. law regarding damages and the practices and procedures in U.S. bankruptcy cases, to reduce the prepetition damage claims resulting from rejection of the contracts under § 365(g) to a low amount. For example, if a contract calling for payment of a percentage of future sales is rejected, the resulting damage claim may in fact be allowed in an amount that will cause the debtor and other creditors to celebrate. The application of the U.S. law of damages in such cases by U.S. bankruptcy courts rarely satisfies the desires of the counterparties.

C. <u>Foreign Representatives Can Attempt to Minimize Cure Obligations When Assuming Contracts for Assignment</u>.

In sales of intellectual property and related transactions, the foreign representative may use U.S. precedents and practices to attempt to reduce the burden of the requisite "curing" of defaults in order to assume contracts, so that they can be assigned under § 365(f). Depending on the facts, the techniques used, and the prevailing Circuit Court of Appeal law that controls the Chapter 15 decision, some defaults may not need to be cured. *See, e.g.*, *In re BankVest Capital Corp.*, 360 F.3d 291 (1st Cir. 2004) (excusing the debtor assuming an equipment lease from its obligation to cure certain nonmonetary defaults); *In re Vitanza*, 1998 WL 808629 (Bankr. E.D. Pa. 1998). *But see In re Claremont Acquisition Corp. Inc.*, 113 F.3d 1029 (9th Cir. 1997) (requiring non-monetary defaults to be cured). Courts have excused some cross-defaults and some impossible-to-cure defaults from being conditions to assumption. *See In re Sambo's Rests. Inc.*, 24 B.R. 755 (Bankr. C.D. Cal. 1982); *In re Sanshoe Worldwide Corp.*, 139 B.R. 585 (S.D.N.Y. 1982).

In other cases, the focus has been on severability issues and the treatment of multiple agreements as a single contract for purposes of assumption or rejection. *See, e.g.*, *Stewart Title Guar. Co. v. Old Republic Nat'l Title Ins. Co.*, 83 F.3d 735 (5th Cir. 1996) (announcing an exception to the general rule that the contract must be assumed or rejected as-is as a whole, and treating the lease in question as two distinct and severable contracts: a lease that could be rejected, and a right to access for copying title records that could be assumed); *In re Plitt Amusement Co. of Wash. Inc.*, 233 B.R. 837 (Bankr. C.D. Cal. 1999) (holding that multiple schedules under a master lease may be considered separate contracts for assumption or rejection). Other defaults may be cured at a lower amount, including by a unique summary process under § 502(c) called "estimation." Several other situations and issues are addressed below in a more comprehensive discussion.

II. Brief Illustrations of How the Foreign Representative Can Improve Transactional Results Under Chapter 15 by Exercising Powers of Trustees in Bankruptcy under the U.S. Bankruptcy Code

In order to maximize the value to the debtor's estate when using § 1521(a)(7) to act like a trustee in bankruptcy in a U.S. case in arranging a sale transaction for bankruptcy court approval, the foreign representative may set up his or her Chapter 15 case with prior rulings in the foreign main proceeding. Consider the following examples to illustrate foreseeable collaborations:

1. Assume (as above) that the foreign representative expects to use §§ 1520 and 1521 to arrange a Chapter 15 sale of U.S. assets free and clear of liens, interests, and (in certain circuits) claims pursuant to U.S. § 363(f). When there is an appropriate "good faith" finding, the court order approving that sale can become final quickly by "mooting" appellate challenges under § 363(m) and other law. Findings by the court in the foreign main proceeding decision can help prove the existence of good faith, even if the adversaries have been served and elect not to participate. More important in cases where there are disputes over ownership of the assets to be sold, the foreign court's resolution of title disputes can be helpful in the Chapter 15 case, even when the adversary declines to submit to the jurisdiction of the court in the foreign main proceeding.

2. Foreign representatives may focus on rejection of U.S. intellectual property licenses and other related contracts pursuant to § 365 by applying the usual U.S. bankruptcy "scream or die" deadline process for qualified licensees to make § 365(n) elections to preserve their rights to the extent possible. However, the foreign representative may attempt to integrate that process into the foreign main proceeding, which would, in effect, require the licensee to submit to the jurisdiction of the foreign main proceeding. Some licensees will decline to do so, thus reducing the volume of § 365(n) elections.

3. Foreign representatives may focus on assumption and then assignment of many otherwise nonassignable contracts (with only a few exceptions) pursuant to § 365, applying the "scream or die" deadline for nondebtor party challenges (a) the assumption of the contracts (*e.g.*, by contesting the adequacy of the proposed "cure" and the adequacy of the assurance of future performance), and (b) the right to assign such contracts. The extent of the required cure, and the treatment of assignments under applicable law, sometimes can be enhanced by obtaining findings in the foreign main proceeding decisions. For example, excuses may exist for nonperformance under applicable foreign law, and a finding of excuse in the foreign main proceeding may expedite the assumption and assignment of the applicable agreements in the Chapter 15 case. Because many nondebtor parties fail to challenge in a timely manner the debtor's transaction, many nonassignable contracts (§ 365(c)(1)) are assigned with fewer cures and less adequate assurances of performance than would have been possible if the counterparty had made a timely objection. Again, if the foreign representative is able to require acts by adversaries that require submission to the jurisdiction of the foreign main proceeding, some adversaries will decline or fail to do so.

4. The foreign representative also may offer releases under U.S. Bankruptcy Rule 9019 in settlement of any U.S. issues that might later affect the buyer, including IP disputes that later may be revisited by nondebtor subsidiaries of the debtor or other affiliates (in some jurisdictions, like the South District of New York, where third-party claims sometimes can be released or impaired by estoppels from bankruptcy court findings on notice to the third parties who failed to object in a timely manner). Some U.S. state laws can be helpful in providing relief to help the buyer escape eventual challenges by the relevant third parties. For example, California Code of Civil Procedure § 877.6 eliminates the "good faith" factor, settling defendants' exposure on co-defendant claims for indemnity and contribution.

5. Foreign representatives and their buyers/assignees also may seek broad retentions of jurisdiction in the Chapter 15 court for disputes involving the buyer and anyone else

who was on notice of the proceedings. Because U.S. bankruptcy judges generally are perceived to be protective of their § 363 sales, a buyer typically finds this to be a cost-effective and attractive way to defend what it considers to be collateral attacks on its purchase transaction.

Unless they are well-advised and organized, third parties in such Chapter 15 proceedings may fail to file a required responsive challenge in time, and may end up disappointed. This is especially common when notice is sent to a less-than-ideal office location of the third party, which often may be offshore or wherever else the interactions historically occurred. (Hint: non-debtors always should immediately file a request for special notice, specifying the preferred address.) Some U.S. debtors also confuse or surprise third parties when their sale motion permits them to change their position at any time until shortly before the hearing (or even at or after the hearing), where they are responding to the winning bidder's preferences. For example, a proposed stalking horse buyer may ask the bankruptcy trustee to reject a particular contract, only later to exercise its right, on the day before the hearing, to have the contract assumed and assigned at a "zero dollar" cure amount with a declaration that includes recitals of adequate assurances of performance by the buyer of the IP at the bankruptcy auction. The counterparty to the contract may rely on the prior proposed rejection and fail to attend the hearing, missing its opportunity to respond to the change in position, and then finding itself with a new assignee who is not obligated to cure past breaches. Given the complications of coordination between the two proceedings, multinational bidders, and often-integrated processes, the foreign representative may find fewer timely responses than he or she may expect in the Chapter 15 cases.

In any event, the foreign representative from the foreign main proceeding generally can ask the court for authority to exercise the powers of a trustee in bankruptcy in the U.S. case. *See* § 1521(a)(7) (authorizing the court to grant the foreign representative "any additional relief that may be available to a [U.S. bankruptcy] trustee," except for specified avoidance-power actions requiring a Chapter 7 or 11 case). Better yet, the foreign representative can choose which assets to sell in the U.S. and which to sell in the foreign main proceeding. For example, if a counterparty to an IP license or other contract appears to be objecting and hostile to the Chapter 15 relief sought by the foreign representative, the foreign representative may choose to deal with that contract initially in the foreign main proceeding, especially if the adversary will be reluctant to submit to the jurisdiction of the foreign main proceeding. The court in the foreign main proceeding can then make findings that the adversary does not contest, for example, as part of a sale conditional on a satisfactory U.S. Court order. The court order in the foreign main proceeding then is submitted in the Chapter 15 proceeding in order to confirm the sale. The foreign representative then can respond to the adversary's challenges in the Chapter 15 case by seeking comity for the decisions rendered in the foreign main proceeding, arguing res judicata, collateral estoppel, etc. This extra argument, when combined with the arguments on the merits and the pressure of the entire sale being held up, may provide powerful reasons for the court to deny the adversary's challenge.

While the foreign representative's adversary may attempt to challenge the quality of justice in the foreign main proceeding, such a challenge will be difficult to prove, particularly now that there is an opportunity for court-to-court communication under Chapter 15. *See* §§ 1525-1527. Once the two professional judges begin to interact, it often will be more difficult for adversaries to convince the Chapter 15 court to reject the decision of the judge in the foreign main proceeding.[11] *Compare In re Hourani*, 180 B.R. 58, 66-69 (Bankr. S.D.N.Y. 1995) (refusing in a former § 304 proceeding to turn over U.S. assets to a Jordanian liquidator because of concerns about due process and other concerns about the local rule of law there) *with Finanz AG Zurich v. Banco Economico SA*, 192 F.3d 240 (2d Cir. 1999), citing *Baker v. Latham Sparrowbush Assocs.*, 72 F.3d 246 (2d Cir. 1995) (requiring proof of problems in the relevant foreign court, rather than merely in the foreign system of law). Perceptions of problems and individual personal experiences of problems are not likely to translate into the kind of proof that can obstruct comity, absent objectively suspicious circumstances, particularly for comity for foreign jurisdictions that share common roots with the U.S. system, such as former British Commonwealth countries and territories, or traditional U.S. trading partners.

Once the assets are sold pursuant to a court process in U.S. Chapter 15 with the related § 1521(a)(7) relief, the foreign representative may seek to distribute the net proceeds in the foreign main proceeding pursuant to § 1521(b). There is a tradition of some deference to foreign distribution proceedings under prior law as applied in some U.S. courts, especially in the Second Circuit. *See, e.g.*, *In re Axona Int'l. Credit & Commerce, Ltd.*, 88 B.R. 597 (Bankr. S.D.N.Y. 1988). However, there also has been some resistance in cases where objecting creditors could prove substantial prejudice in the individual case as a result of foreign laws that would have caused them to receive far lower recoveries offshore than in a U.S. proceeding. *See, e.g.*, the multiple decisions of *In re Bd. of Dirs. of Multicanal, S.A.*, 340 B.R. 154 (Bankr. S.D.N.Y. 2006) (regarding the Argentine Acuerdo Prentivo Extrajudicial "APE" proceeding); *In re Treco*, 240 F.3d 148 (2d Cir. 2001) (no turnover to Bahamanian liquidators under § 304 where administrative claims would have stripped the U.S. secured creditor's collateral); *In re Toga Mfg., Inc.*, 28 B.R. 165 (Bankr. E.D. Mich. 1983) (denying § 304 turnover to strip U.S. lien in Canadian proceeding).

However, many expect the Chapter 15 turnovers to become more common, both because the § 1521(b) "sufficient protection" standard appears comparatively easier to satisfy than prior tests and because § 1508 requires U.S. courts to accommodate foreign courts' interpretations of the U.N. Model Law to promote global uniformity. Many academic commentators and advocates of the Model Law are promoting global distribution from the foreign main proceeding without considering the greater local prospects for U.S. Creditors' recovery from local U.S. assets. U.S. creditors' fears about Chapter 15 courts following such an accommodating reading of the "sufficient protection" test may lead to U.S. involuntary bankruptcy petitions being filed under Chapter 7 or 11 in order to force a more U.S.-oriented standard for foreign distribution of U.S. assets under § 1529.

[11] The U.N. Model Law reflects the concept of respect for each nation's sovereignty and chosen legal process. Tests of the quality of rule of law and the reliability and integrity of the courts are not incorporated into this Model Law. Therefore, it may be more challenging to resist, in Chapter 15 cases, decisions of courts in foreign main proceedings than it is to challenge other foreign court decisions for other purposes, such as, for example, under the Uniform Foreign Money Judgments Recognition Act. *See, e.g.*, *Bridgeway Corp. v. Citibank*, 201 F.3d 134 (2d Cir. 2000) (rejecting a Liberian court judgment); *Bank Melli Iran v. Pahlavi*, 58 F.3d 1406 (9^{th} Cir. 1995) (rejecting an Iranian court judgment); 13 ALR Fed. 208.

III. Rejection of U.S. Executory Contracts and Licenses under §§ 365 and 1521(a)(7) Can Present Some Surprising Possible Advantages in Cross-Border Insolvencies

A. The Foreign Representative or His or Her IP Buyer Can Reject Licenses and Related Contracts Encumbering Estate-Owned IP and Then Exploit Weaknesses in § 365(n) Protections for Rejected Licensees.

The foreign representative can reject (with court approval) IP licenses and related contracts under 11 U.S.C. §§ 365 and 1521(a)(7). The rejected licensee then can elect under § 365(n) to retain certain benefits under the narrowly defined "intellectual property" that was licensed and certain "supplementary agreements" (an uncertain and highly debated category). However, the rejected licensee can pay a high price for the § 365(n) election: as noted above, the licensee will be obligated to make full payment of royalties, without offset, in exchange for what is merely, in effect, a right to be "left alone" as to only a portion of the typical bundle of what the rest of the world calls "intellectual property." As noted elsewhere, "intellectual property" is narrowly defined in U.S. Bankruptcy Code § 101(35A) to *exclude*, among other things, trademarks, foreign patents, and foreign copyrights. As a result, the foreign representative often can arrange to do the following:

1. reject the licenses and contracts encumbering the estate's IP, improving the value of that IP to a buyer;

2. sue for infringement of the estate's trademarks, foreign patents, and foreign copyrights, or sell the right to do so to the IP buyer under § 363(f);

3. force the rejected licensee either to (a) pay full royalties without offset, if it elects to retain its U.S. patent and copyright protections under § 365(n), or (b) accept rejection and then face suit for infringements against all IP, including the U.S. patents and copyrights; and

4. limit the rejected licensee's prepetition damage claims under § 365(g), including by threatening to use the licensee's claim as an admission of liability in the infringement actions. For example, if the rejected licensee files with the debtor's estate a huge § 365(g) claim for rejection on account of consequential damages flowing from loss of the license, the IP buyer arguably can use that admission against the licensee.

B. Rejecting Contracts to Replace Royalty and Other Obligations with Lesser Bankruptcy Claims and Related Tactics.

Under some transactions, IP is assigned by its creator or his or her successor subject to payment of a royalty and other rights, including perhaps a license. The contract can be rejected under § 365 by the foreign representative, whose debtor's estate owes the royalty and other obligations, using the Chapter 15 power under § 1521(a)(7) to request court consent for use of the powers of a trustee in bankruptcy in the U.S. When the IP is sold under § 363(f) free and clear and clear of liens, interests, and (in certain circuits) claims, the IP buyer typically also will require contracts either to be assumed and assigned to the buyer or rejected. (Indeed, even if the buyer does not bargain for rejection, the debtor typically will need to reject the contracts that are not assumed and assigned, because the debtor usually will not have any ability or incentive to attempt to perform under the agreements or to try to find another buyer for them.) This portion of the discussion addresses the prepetition unsecured claims of the nondebtor party to the rejected contract under § 365(g) and related tactics.

Consider the following illustrations of the tactical results for the estate in the foreign main proceeding and the related Chapter 15 case. First, when the IP is sold free and clear of liens and interests and (in certain circuits) claims under § 363(f) and the contracts are rejected under § 365, the foreign representative's debtor owes no further royalty payment obligation under the contract. Instead, there is only a prepetition unsecured damage claim against the foreign representative's estate under § 365(g), which (as described below) is often unsatisfying in its calculation. This means that the foreign representative's IP buyer can sue for infringement, and that the counterparty may have neither an effective offset (see below) or an easy way to add that to its rejection damage claim. What defendant would want to argue that it has massive infringement liability to the IP buyer, merely so that it can better argue for a higher allowed claim in the bankruptcy case?

Moreover, in a cross-border bankruptcy, the foreign representative often may have its choice of whether to use the foreign main proceeding to calculate the rejected party's IP rejection claim or to use the Chapter 15 case to do so. Sometimes the foreign representative will seek to have the claims calculated in the foreign main proceeding merely because some counterparties may be unwilling to subject themselves to the jurisdiction of the court in the foreign main proceeding, whether out of fear of adverse decisions later being given comity/res judicata or collateral estoppel effect in the U.S., out of fear of broader submission to foreign jurisdiction for other litigation, or otherwise. In any event, the allowed claim may produce a reduced recovery for that creditor from the foreign main proceeding, even when the U.S. asset sale proceeds are shifted by the Chapter 15 court to the foreign main proceeding for distribution under § 1521(b), because of greater administrative, priority, statutory lien, and other claims to which such party's claim is subject to dilution or priority payment.

The following are among problems typically suffered by nondebtor counterparties entitled to royalty payments until their contracts are rejected:

1. The U.S. bankruptcy court may not be generous in its calculation of the present value of future royalty income, because the debtor may not have been successful with the IP in the past and because the counterparty cannot effectively prove how much future profit the IP buyer expects to make on the IP.[12] This allowed claim typically will be especially low, if it is "estimated" under § 502(c) rather than being determined in a full trial where the damage calculation experts can be better tested;

2. The foreign representative's buyer typically acquires many assets, including the IP at issue, in a bundle for one price. Typically, the buyer will be allowed to allocate the sale proceeds among assets in order to best advance its tax position (*e.g.*, maximum depreciation deductions and tax credits) and other tactics, regardless of the comparative values in

[12] The IP buyer's profit expectations likely are to be regarded as proprietary trade secrets that are not easily, or perhaps are never, discoverable in such litigation. The typical reality is that the buyer will vigorously resist disclosure, and the trial of the main disputed issues often will come up in the bankruptcy case before there is any meaningful discovery production on the disputed trade secret issue. Many bankruptcy courts are slow to chill bidding with the threat of making the buyer reveal future plans and internal valuations and strategies.

the "real world" in the abstract. Thus, the fact that the buyer received a windfall in profit on the IP purchase by ducking the real royalty obligations often can be obscured during the debate over the claim allowance for rejection;

3. When the IP buyer sues the nondebtor counterparty for infringement, the nondebtor counterparty arguably loses its royalty offset, *i.e.*, there is no longer mutuality, since the counterparty's claim is against the rejecting debtor, rather than against the IP buyer;

4. The rejected contract may include consequential damage waivers, limitations, or other exculpations that arguably apply to reduce the counterparty's § 365(g) damage claim (*e.g.*, waivers of consequential damages, caps on damages, or such as a portion of royalties paid), creating a circularity and other complications; and

5. Bankruptcy courts often are regarded by nondebtors as difficult places to win large allowed claims that are perceived by the nondebtor party to be truly compensatory. Moreover, in the "zero sum game" that often applies in bankruptcy cases, the other creditors may be happy to support the foreign representative in minimizing such rejection claims, so that there is more for the other creditors to share.

Because of the confusion and discord in U.S. bankruptcy law as interpreted in the various Circuit Courts of Appeal regarding the treatment of, or the effect of rejection of, IP licenses and contracts,[13] one recent case may serve as a useful illustration.[14] In *Thompkins v. Lil Joe Records, Inc.*, 476 F.3d. 1294 (11th Cir. 2007), a rap artist exclusively assigned to a recording company copyright licenses in all of his musical compositions in exchange for royalties, and made other related deals. The recording company filed Chapter 11 and a plan of liquidation in which (i) the IP and other assets were sold under § 363(f), and (ii) the executory contracts were rejected under § 365. The rejection under § 365 did *not* dissolve the contract or cause a rescission voiding the contract or putting the parties back in their original positions. Instead, rejection freed the debtor's estate from the obligation to perform in the future, and left the counterparty with a prepetition unsecured damage claim for breach under § 365(g), instead of receiving any further right to royalty payments from the buyer. Such a rejection damage claim (as described above) often will be unsatisfying to a nondebtor counterparty such as this. According to the decision, the effect of rejection was to free the debtor's estate from any *further* obligation to perform royalty payments, without having any impact on the *executed* portions of the contract, which continued without being cancelled, repudiated, rescinded or otherwise terminated. (Serious disputes continue among the courts about this simplistic formulation, because the rejection

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[13] One common instance of "IP heresy" in bankruptcy is the mistaken practice of treating what are labeled as "exclusive" patent licenses as if they were like exclusive copyright licenses. The laws of patent and copyright are fundamentally different, as are the related licensing practices and, accordingly, so should their treatment be in bankruptcy. To assume that free assignment of exclusive copyright licenses under § 365(f) also means free assignment of exclusive patent licenses, for example, is a mistake. *See* note 7, *supra*. This is true especially when most "exclusive" patent licenses are only exclusive in a particular field of use or territory, making them more like nonexclusive licenses for the purpose of assumption and assignment under § 365(c)(1).

The difference in treatment of important bankruptcy issues among the different U.S. Circuit Courts of Appeal continues to be a major variable in results for the parties. This is especially true regarding bankruptcy and IP issues.

[14] Patent cases are generally more important and useful illustrations than copyright cases. However, here the focus is on § 365 variables, where there is common ground.

breach arguably also creates defenses under both law and the contract, as well as rights to terminate the executed portions of the contract, subject, of course, to the automatic stay. Thus, questions persist as to the effect, if any, for example, of damage limitations, exculpations, and other provisions of the rejected contract that affect the damage calculation under § 365(g).)

Assume that a foreign representative from a foreign main proceeding arranges in the U.S. Chapter 15 to reject the IP license and related contracts of a U.S. licensee/collaborator dealing with a foreign licensor/debtor in the main proceeding. *See* § 1521(a)(7) and related discussion above. One consequence is that the U.S. licensee can attempt to make an election under § 365(n) to retain its right as the rejected licensee in order to avoid patent and copyright infringement liability *in the U.S.*, albeit at a high cost.[15] *See* section A above. The relevant issue, however, is the ability of the foreign representative to deny any foreign protection to the rejected licensee under § 365(n). In effect, the U.S. rejection sets up foreign and trademark infringement suits.

Among the many other interesting issues arising in this context is the fate of venue selection, submissions to jurisdiction, arbitration, and other boilerplate rights in an agreement. If any provision is deemed to be an "executed" part of the contract (*i.e.*, a vested property right), then it arguably should survive rejection. If the provision is a mere covenant and, therefore, merely an "executory" provision, then future performance arguably is excused by rejection, although the rejection gives rise to a prepetition unsecured damage claim for breach under § 365(g), which is typically of limited value on such issues. Volumes could be written about the treatment of arbitration clauses in U.S. bankruptcy cases, but the effect of rejection under § 365 is still developing. *See, e.g.*, "Jurisdiction in Bankruptcy Proceedings: A Test Case for Implied Repeal of the Federal Arbitration Act," 117 HARV. L. REV. 2296 (2004) (arguing, among other things, that § 365 rejections prevail over the Federal Arbitration Act). Since arbitration clauses are somewhat severable from the contract (*see, e.g.*, *Prima Paint Corp. v. Flood & Conklin Mfg.*, 388 U.S. 395, 404 n.12 (1967)), they may be more vulnerable than some think, as some have predicted for a long time. *See* 9 U.S.C. § 2 (an arbitration clause in invalid if "grounds" exist at law or equity for the revocation of any contract," which is what § 365 does); Jay Westbrook, "The Coming Encounter: International Arbitration and Bankruptcy," 67 MINN. L. REV. 595 (1983).

C. Increased Ability of a Foreign Representative to Sequence a Unified Cross-Border Strategy with Chapter 15 in Order to Maximize His or Her Position.

Consider the following illustration:

[15] Under § 365(n), the rejected licensee retains the right not to be sued for infringement for conduct under the scope of the narrowly defined "intellectual property" (§ 101(35A)) license and certain "supplementary agreements," if the licensee waives its offsets for the absence of all other licensor performance and pays full royalties with no benefit except to be "left alone." However, the definition of "intellectual property" in § 101 excludes trademarks and foreign protection, apart from what is protected under U.S. Title 35 for patents, under Title 17 for copyrights, and under Chapter 9 of Title 17 for mask works. This means that the foreign representative can sue for infringement as to what the rejected licensee does outside the U.S., but the rejected licensee must pay full royalties without offset under § 365(n), if it wants to avoid patent and copyright infringement exposure in the U.S. *See* subsection A, *supra*. While there is now a U.S. legal specialty among bankruptcy lawyers to attempt to "bankruptcy-proof" these transactions, many problems remain difficult to solve.

1. A foreign representative arranges to reject a license and related contracts in a Chapter 15 case with all U.S. parties thereto, applying for relief under § 1521(a)(7) for use of § 365;

2. Following rejection, the foreign representative uses the rejection by the U.S. court as grounds in the foreign main proceeding to enforce its foreign rights outside of any § 365(n) protection in the U.S. for the U.S. license. *See* subsection A, *supra*. This includes using the U.S. rejection arguably to avoid enforcement of the arbitration arrangements in the contracts, so that the foreign main proceeding court itself can act; and

3. Decisions of the court in the foreign main proceeding can then be imported back to the U.S. Chapter 15 through comity/collateral estoppel/res judicata or otherwise to the extent that they provide benefits in disallowing, equitably subordinating, (§ 510(c)) or otherwise impairing the claims or defenses of their U.S. adversaries in IP disputes or in Chapter 15 claim-allowance disputes.

One issue that arises under a situation such as is set forth above is that willful infringement claims likely will be addressed more craftily in future cross-border insolvencies. The court in the foreign main proceeding may make findings on relevant issues that are designed to:

(a) shelter the debtor from "willfulness" exposure—for example, seeking findings that negate certain factors in any U.S. willfulness decision; and

(b) increase the strength of the debtor's case for the willfulness of the nondebtor infringer.

This leverage derives some of its power from the impact of foreign decisions on IP litigation and damages or offsets in U.S. Chapter 15 cases, as noted herein. Historically, where patent infringement was not found to be willful, the plaintiff would only recover compensatory damages at least equal to a reasonable royalty. Now most plaintiffs are not merely pleading, but also are fighting for "enhanced" damage awards of up to a multiple of three pursuant to 35 U.S.C. § 284 for "willful infringement." *See Read Corp. v. Portec, Inc.*, 970 F.2d 816 (Fed. Cir. 1992). Patent legal opinions are usually asserted as a defense to willfulness allegations, but one study showed that they only avoid willfulness findings in half of the cases in which infringement was the judgment result. *See, e.g., Knorr-Bremse Sys. Fuer Nutzfahrzeuge GmbH v. Dana Corp.*, 344 F.3d 1336 (Fed. Cir. 2004) (new rules for opinion defenses); *Underwater Devices, Inc. v. Morrison-Knudsen Co.*, 717 F.2d 1380 (Fed. Cir. 1983) (competent opinion evidence test).

The comity/res judicata/collateral estoppel rulings in Chapter 15 cases can make applicable those factors in decisions in foreign main proceedings in such cases, especially where the contractual arbitration arrangements are rejected.

IV. Coming Next to your Local Chapter 15 Court: Patent Trolls Advancing Their Litigation Strategies and Marketing Interests in Litigation Proceeds

Apart from the usual cross-border mergers and acquisition activity as distressed companies liquidate their IP, there are also many other IP litigation strategies that will involve Chapter 15. Imagine a foreign main proceeding forum in which the debtor is a "patent troll"[16] with a compatible foreign representative. The reason that some trolls may file for insolvency proceedings is that their patent portfolios recently have come under widespread attack for obviousness under the new Supreme Court standard stated in the *KSR* case discussed below.[17] For a variety of tax, political, and other reasons far beyond the scope of this article, investors may prefer to invest in particular litigation cases than in the offshore troll fund itself.[18] An insolvency proceeding, whether the foreign main proceeding or the U.S. Chapter 15, can provide a convenient and reliable forum for investors to "buy into" particular IP infringement litigation by acquiring a share of the net proceeds without impairing the standing of the foreign representative/plaintiff IP owner in the litigation.

To examine the future prospects for multi-jurisdictional conflicts, one may start with a simple example of an infringement suit alleging U.S. patent infringement. *See, e.g.*, *ArrivalStar, S.A. v. UAL Corp.*, No. 07CV02385 (N.D. Ill. Apr. 30, 2007) (complaint by Luxembourg licensee and BVI patent-owner corporations claiming that United Airlines' "Easy Update Flight Notification" system infringes their U.S. business-method patents). Imagine what would happen if a BVI plaintiff were to commence a foreign main proceeding in Tortola, BVI and a Chapter 15 case in Chicago, where the infringement action is pending and where the defendant inevitably will counterclaim, challenging the validity of the patents. *See* 28 U.S.C. 1410(2). Imagine further that the plaintiff is a "troll" seeking to replicate another "Blackberry kill" (the term some trolls like to use for the settlement that RIM was forced to pay in order to resolve its recent patent litigation, as the patent infringement injunction nearly forced it out of business in the U.S., because the judgment for the plaintiff preceded the result of the reexamination challenges at the PTO to the underlying patents). *See* 35 U.S.C. § 301, *et seq.*[19]

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[16] A patent troll is an investor whose principal business is IP litigation using a portfolio of patents (often a "mixed bag" of weak and stronger patents) to sue operating businesses for IP (usually patent) infringement, employing contingent-fee lawyers, and typically seeking license fee settlements. Often the goal is to sue many target "infringer" defendants, calculating that the troll can achieve "license" revenue from settlements at a lower cost than the high cost of defense, as well as risk and other factors, for the defendants. Sometimes the goal is to gamble on obtaining an infringement judgment against one or a couple of successful companies who can afford to pay a huge settlement; *i.e.*, what is referred to by some as the "Blackberry kill." Some contingent-fee plaintiff lawyers seem to be moving into this IP litigation business away from other plaintiff specialties with less current activity (*e.g.*, asbestos, tobacco, environmental, labor, etc.).

[17] Clearly, some trolls have large portfolios of business-method patents and combination patents that are vulnerable to "obviousness" challenges. Defending their patents at the PTO will require a larger cash expense than they had expected, and under the new Supreme Court standard, they are now at much greater risk than before. Therefore, their expenses are escalating, while their portfolio values erode and their settlement revenue declines.

[18] Short-sellers, competitors, and other parties may have an interest in encouraging litigation against particular targets. Such offshore vehicles may be perceived as safe places for anonymous investments in such offshore funds, where it is difficult for defendants to identify the real source of the funds.

[19] The U.S. Supreme Court decisions have begun to reduce the troll activity by making injunctions less automatic (*eBay*) and, more recently, making the standard for "obviousness" easier for defendants seeking to invalidate

One question that arises is how such a plaintiff could integrate the dual insolvency proceedings in BVI and the Chicago Chapter 15 into its consolidated litigation strategy. The short answer is that there are at least 33 specific tactical enhancements for such litigation by the use of cross-border insolvency proceedings.[20] To pick just one of those possible tactics as an obvious example, consider that the "Blackberry kill" strategy is enhanced by exploiting a flaw in the U.S. system that allows infringement litigation to proceed faster than the PTO process for reexamining patents that arguably never should have been issued in the first place, including because they were too "obvious."[21] *See* 35 U.S.C. § 301, *et seq.*, and *KSR Int'l. v. Teleflex*. Now that the Supreme Court has allowed "common sense" back into the "obviousness" test of patents, what can trolls be expected to do? One answer is to attempt to use Chapter 15 stays, injunctions, and other procedures in the U.S. to delay reexamination of the challenged patent by the PTO, while their litigation proceeds. If the already-slow PTO is obstructed by Chapter 15 orders and stays, for example, the "Blackberry kill" strategy may continue.

Of course, defendants can be expected to respond to such strategies, but there are several items to consider. Yes, issues can be raised about (i) whether and how the § 362 automatic stay operates in this context (§ 1520), (ii) whether the PTO reexamination process under 35 U.S.C. § 301, *et seq.*, is exempt from the stay under § 362(b)(4) as a "police or regulatory power," and (iii) whether or not the defendant violates the stay by exercising what it regards as the constitutional right to petition its government for relief. But remember that the foreign representative may challenge the defendant's standing as a creditor (making a claim purchase by the defendant for standing to be prudent), and, as a result, the already frustrated defendant could become embroiled in litigation in at least two forums and, if it dares to participate in the foreign main proceeding,[22] three forums. This extra expense and hassle may make the troll's "license

patents, particularly the "business method," "combination," and other patents that are frequently used by trolls in their controversial litigation. *See KSR Int'l. v. Teleflex, Inc.*, No. 04-1350, 2007 WL 1237837 (U.S. Apr. 30, 2007) (expanding the challenges for obviousness as a means to invalidate patents that many say common sense should have prevented from ever being issued by the PTO, *e.g.*, the "fruit salad argument" about whether combining an obvious apple and an obvious orange deserves a patent for the "invention" of fruit salad). Nevertheless, some trolls continue to raise funds from investors and to find eager contingent-fee plaintiff lawyers to pursue infringement litigation, despite such criticisms and risks.

[20] The purpose of this article is not to give free strategies to trolls, but rather to illustrate how we can expect Chapter 15 to be used in the future in ways that were not obvious either to advocates of the UNCITRAL Model Law or to Congress when it passed Chapter 15.

[21] Some critics note that part of the U.S. problem is that the patent applicant is the one responsible for bringing to the attention of the PTO the "prior art" that would raise issues about the obviousness of the invention. If the applicant fails to present obvious prior art, and if the overworked PTO clerks approve the patent, the system is slow in correcting the "mistake" when competitors then come forward seeking reexamination (35 U.S.C. § 301, *et seq.*) after the patent is issued with evidence of prior obviousness that was not previously considered by the PTO. Meanwhile, the mistakenly issued patent is presumed to be valid, and can be used by trolls or others to commence infringement suits.

[22] Depending on the external perception of the quality of the "rule of law" in the particular forum, defendants may hesitate to subject themselves to the jurisdiction of the court in the foreign main proceeding. Once there for one purpose, the defendant may fear finding itself in an unfriendly system that can issue orders that can then be "imported" to the Chapter 15 case or other courts for comity and, perhaps, even with res judicata or collateral estoppel effects.

fee" settlement offer look more enticing.[23] In any event, the issue is whether Chapter 15 can enhance the trolls' litigation strategy, and the answer seems to be "Yes."

V. Conclusion

When the foreign representative plans his or her Chapter 15 strategy, he or she may find it useful to ask what a trustee in bankruptcy in a U.S. case could do in similar asset-sale and contract-resolution situations. The foreign representative can gain comparable rights under §§ 1520 and 1521(a)(7), and then add those opportunities to an integrated strategy with his or her other rights in a foreign main proceeding. The combination of powers in both proceedings creates the opportunity for enhanced recoveries for the foreign representative.

[23] The economics of the troll business often are based on using even weak patents to assert infringement claims against many potential "infringers," so that the troll can profit through volume by even comparatively small individual settlements for "modest" license fees, compared to the defendants' high defense costs and even where the risk of adverse litigation decisions is low. Some frustrated defendants call this the "dynamite the reef" style, by analogy to the fishing technique sometimes used by environmentally destructive fishermen who throw dynamite in the shallow water of a coral reef, then scoop up all the fish that are stunned or killed by the concussion and float to the surface. Because the cost of defense of even a meritless claim often exceeds the cost of a settlement "license," even a small risk makes settlement seem attractive to the defendants.