SUFFOLK UNIVERSITY LAW SCHOOL
JOURNAL OF HIGH TECHNOLOGY LAW

VOL. I | 2002 | NO. 1

ARTICLES

Cite as: 1 J. HIGH TECH. L. 1 (2002)

The Internet Bankruptcy: What Happens When the Bell Tolls for the eCommerce Industry?

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AN INTRODUCTION TO E-COMMERCE AND INSOLVENCY ISSUES

Not long ago most business and intellectual property lawyers representing Internet start-ups thought they had no need for knowledge of the bankruptcy world. Bankruptcy attorneys knew no better, thinking that Internet companies never really failed – at worst they just closed their doors quietly while the VC paid any creditors. Both sides of the fence know better now and are learning that the technologies that revolutionized intellectual property law, tort law, and business have the potential to also revolutionize bankruptcy and commercial law. The last two years saw a trickle of eCommerce and telecommunication bankruptcies turn into a flood and, along the way, found several books and articles published by the people on the front lines.[1] This article summarizes some of the relevant and emerging issues.

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1. WARREN E. AGIN, BANKRUPTCY AND SECURED LENDING IN CYBERSPACE, 2ND EDITION (Bowne & Co., Inc. 2000, 2001), THOMAS M. WARD, INTELLECTUAL PROPERTY IN COMMERCE (West Group 2000), Jonathan C. Lipson, *Financing Information Technologies: Fairness and Function*, 2001 WIS. L. REV. 1067 (2001), Brent R. Cohen and Thomas D. Love, *Acquiring and Enforcing Security Interests in Cyberspace Assets*, 10 J. BANKR. LAW & PRAC. 423 (2001), William P. Weintraub, *Reorganizing High-Tech Businesses – "I Need Help, Find Me Some Lawyers Who Wear Suits,"* 9 J. BANKR. LAW & PRAC. 547 (2000), Marjorie Chertok and Warren E. Agin, *Restart.com: Identifying, Securing and Maximizing the Liquidation Value of Cyber-Assets in Bankruptcy Proceedings,* 8 AM. BANKR. INST. L. REV. 225 (2000).

 ISSN 1536-7983

The .com Phenomenon

The late 1990's were generally an unhappy time for bankruptcy attorneys. A strong economy and expanding financial markets greatly reduced the number of business bankruptcies filed. Chapter 11 business bankruptcy filings dropped from 13,379 cases in the year ending September 1994 to 7,953 cases during the year ending June 1999.[2] This change coincides with an incredible expansion of the information technology (IT) industry, resulting, in large part, from the Internet's integration into U.S. society and business.

The Internet is a major component of the networks and non-networked applications generally referred to as "cyberspace." The term generally applies to "any interactive environment that is or can be outside of real time and real space."[3] The term cyberspace references the network of computers that can be accessed over the Internet, and the information available on that network.[4] The Internet is not as new as some might think. Its predecessor, ARPANET (the Advanced Research Projects Agency Network of the U.S. Department of Defense), was completed as far back as 1970. The current TCP/IP transmission protocol went into use in 1982. However, it was not until HTTP (hyper text transfer protocol) was established in 1991 and the Mosaic browser created in 1993 that the Internet as we now know it began to emerge.[5]

Still, at the end of 1994 only 10,000 Web site servers were connected to the Internet. By August 1999, that number had increased to more than seven million.[6] Today, HTTP allows the World Wide Web, which consists of millions of connected Web sites and is what most people think of when they think of the Internet. The Mosaic browser has gone through several transformations to become Netscape Communicator. Hundreds of millions now use it or similar Web browsers to surf the Internet.

Understanding the Internet's impact on future bankruptcy practice requires examining how the Internet has changed technology use in U.S. business. After all, the computer industry is not a new industry, technology-oriented bankruptcies are not new, and businesses have used computers since the 1940's. The difference is that the Internet raises the stakes. Businesses using tools made available by the Internet gain such an advantage that they can't afford not to use them. Law practice provides a convenient example. Three years ago many major law firms had neither e-mail nor Web sites, and not all attorneys used personal computers. Today, almost all major firms realize that they must integrate computing into their practices in order to remain competitive. Without e-mail, attorneys don't have the ability to communicate with clients in the manner clients require. Without a Web site, firms can't project a world-class image. The software required to work collaboratively with clients and other firms does not run on older DOS based computers, nor

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2. Administrative Office of the United States, *Press Releases* (Dec. 17, 1999), *at* http://www.uscourts.gov/Press_Releases/.

3. HAYDEN MEAD AND BRAD HILL, THE ON-LINE/E-MAIL DICTIONARY (Berkeley Books, 1997).

4. For a fuller discussion of the term 'cyberspace," *see* JOHN DECEMBER AND NEIL RANDALL, THE WORLD WIDE WEB UNLEASHED, pgs. 328-333 (2d ed. 1995).

5. Robert H Zakon, *Hobbes' Internet Timeline V5.6* (April 1, 2002), *at* http://www.isoc.org/zakon/Internet/History/HIT.html.

6. *Id.*

will the software needed to access the Internet, so firms are forced to upgrade their computer systems.

Today any major corporation has a Web site and probably uses it to sell goods, automate its supply function, or otherwise operate its business. Software systems, especially database management programs (like Oracle) and enterprise communication tools (like Lotus Notes or SAP) form the backbone of most corporations. Without these technology systems, the businesses cannot exist. Domain names are valuable property and companies will pay six or even seven figure sums to obtain the rights to their domain name.

Technology issues play a greater role in present bankruptcy cases partly because technology, and new forms of technology, are now more pervasive in industry. Moreover, the acceleration in the U.S. economy was information technology based. The winners in the stock market were not the brick-and-mortar companies, but the software companies, the computer companies, and the .com start-ups. These companies on the cutting edge were the first to fail when the business cycle turned downward.[7] Technology related issues play a major role in their bankruptcy cases. The same is true for the non-technology companies that rely on technology-related assets to sustain business operations.

The increased importance of information technology in U.S. industry has another effect. The concepts of information technology property law are now more important, and have a higher profile, than before. Attorneys and legislatures are focusing more on intellectual property law, software licensing, privacy law, and electronic signatures and documents. New statutes, such as the Uniform Electronic Transactions Act (UETA), the Uniform Computer Information Transactions Act (UCITA), the Electronic Signatures in Global and National Commerce Act (E-SIGN), and revised U.C.C. Article 9 are changing the legal landscape and focusing attention on e-commerce issues.

RECOGNITION OF ELECTRONIC DOCUMENTS AND SIGNATURES

Three new statutes will enable the use of electronic forms of documents and signatures in both consumer and commercial transactions. These statutes — revised Article 9 to the Uniform Commercial Code, the Uniform Electronic Transactions Act (UETA), and the Electronic Signatures in Global and National Commerce Act (E-SIGN) — will result in new forms of transactions that, while functionally equivalent to familiar forms, will look very different. This will require bankruptcy attorneys to rethink how they examine the effect and validity of commercial instruments. For example, imagine possible treatment of negotiable instruments that do not exist in paper form.

Revisions to U.C.C. Article 9

The current revision to U.C.C. Article 9 was approved and recommended for enactment at the annual meeting of Uniform Law Commissioners on July 30, 1998, approved by the American Law Institute in 1999, and uniformly enacted into law in all fifty states effective July 1, 2001. Revised Article 9 eliminates

7. Josh Martin, *Down But Not Out*, MANAGEMENT REVIEW, December 1999, at 57.

the writing and signature requirements contained in the current Article 9[8] and instead recognizes electronic means of authenticating documents. The concepts of "writing" and "sign" are replaced with the concepts of "record" and "authenticate." The term "record" is defined as "information that is inscribed on a tangible medium or which is stored in an electronic or other medium and is retrievable in perceivable form."[9] This definition encompasses the definition of "writing," that remains unchanged as part of Article 1, but will also include electronic information. The term "record" will include documents created using computer applications, such as Word documents, data designed for use with EDI systems, and digitized writings.

A person can "authenticate" a record by "signing" it,[10] or by executing or adopting a symbol, or encrypting a record in whole or in part with "present intent to: (i) identify the authenticating party; and (ii) adopt, accept, or establish the authenticity of a record or term."[11] This definition of authenticate is designed to allow a party to create enforceable electronic documents. The terms "authenticate" and "record" have replaced the terms "writing" and "sign" throughout most of the revised Article 9, including Section 9-203, which governs enforceability of security agreements. Under the revised Article 9, a security agreement is enforceable if authenticated. It no longer needs to be in writing.[12]

The Article 9 revisions also allow for the creation of security interests in electronic documents and other intangible assets. The revised Article 9 recognizes that while a payment obligation may exist in electronic form, it may still possess qualities of general intangibles because of the lack of a writing. For example, the possession requirement for certain types of instruments becomes difficult to satisfy with an electronic document. The revision defines monetary obligations in intangible form as "payment intangibles"[13] and includes them in the definition of general intangibles.[14] Consequently, perfection can be accomplished by filing a financing statement.[15]

One type of secured transaction significantly impacted by the Internet is transactions involving chattel paper. Chattel paper is a form of agreement, common in both consumer and business transactions that evidences both a monetary obligation and a security agreement in or lease of identified goods.[16] If one or more documents is used to document the financing transaction, the

8. The U.C.C. includes a "writing" requirement that certain documents are unenforceable unless they are printed, typewritten, or otherwise intentionally reduced to tangible form. U.C.C. § 1-201(46) (1995). In the Article 9 context, several provisions require that certain documents be in writing to be enforceable. This includes security agreements and financing statements. The U.C.C. also contains a signature requirement for many documents including security interests and financing statements. A signature is defined as "any symbol executed or adopted by a party with present intention to authenticate a writing." U.C.C. § 1-201(39) (1995). These provisions belong to a statute whose last major amendment occurred in 1977, at a time when no one could predict the pervasive influence of computers in today's society.

9. U.C.C. § 9-102(a)(69) (1999).

10. U.C.C. § 9-102(a)(7)(A) (1999).

11. U.C.C. § 9-102(a)(7)(B) (1999).

12. U.C.C. § 9-203(b)(3)(A) (1999).

13. U.C.C. § 9-102(a)(61) (1999).

14. U.C.C. § 9-102(a)(42) (1999).

15. U.C.C. § 9-310(a) (1999).

16. U.C.C. § 9-105(1)(b) (1995).

group of documents taken together constitutes the chattel paper.[17] The rules governing security interests in chattel paper contained in the U.C.C. are necessary to simplify transactions involving the sale or lease of goods or equipment with financing terms. Traditionally, the documents used in the transaction must be in writing and signed by the borrower to qualify as chattel paper.[18]

With the advent of electronic business transactions, including electronic commerce conducted over the Internet, chattel paper can be created as a result of transactions that do not create paper documents. For example, assume a business purchases a computer system over the Internet. The purchaser fills out an electronic form and "agrees" to pay for the computer through installment payments and grant the seller a lien against the computer by attaching a digital signature to the form. Assuming that this creates an enforceable contract and security interest, the seller needs a mechanism to finance its extension of credit. It does this by either selling the resulting chattel paper to a finance company, or by borrowing funds using the chattel paper as collateral. The chattel paper, consisting of the data record created by the transaction and the record of the purchaser's digital signature, is electronic. If the U.C.C. definition of chattel paper excludes electronic records, the seller can not obtain financing, and can not sell goods over the Internet on credit.

The Article 9 revisions address this problem by defining categories of tangible and intangible chattel paper. The requirement that chattel paper be in "writing" is eliminated, and replaced by a requirement that chattel paper consist of a record or records.[19] When the record or records that evidence the chattel paper are written or otherwise inscribed in tangible form, the chattel paper is referred to as "tangible chattel paper." [20] When the records are stored in an electronic medium, the chattel paper is referred to as "electronic chattel paper."[21]

Tangible chattel paper is treated substantially as it was under the original U.C.C.. A security interest can be perfected by filing a financing statement[22] or by possession.[23] Filing can also perfect a security interest in electronic chattel paper.[24] The concept of possession is difficult to apply to electronic documents because of the ease with which they can be duplicated. To solve this problem, the revised U.C.C. uses the concept of "control." Under the revised U.C.C. Article 9 obtaining "control" of the chattel paper can perfect a security interest in intangible chattel paper.[25] The security interest remains perfected from the date the secured party establishes control and continues as long as the secured

17. *Id.*
18. *Id.*
19. U.C.C. § 9-102(a)(11) (1999).
20. U.C.C. § 9-102(a)(78) (1999).
21. U.C.C. § 9-102(a)(31) (1999).
22. U.C.C. § 9-312(a) (1999).
23. U.C.C. § 9-313(a) (1999).
24. U.C.C. § 9-312(a) (1999).
25. U.C.C. § 9-314(a) (1999).

party retains control.[26] A new section describes how a creditor obtains control over electronic chattel paper.[27]

The Uniform Electronic Transactions Act

The National Conference of Commissioners on Uniform State Laws (NCCUSL) adopted the UETA on July 29, 1999. The UETA's purpose is to provide a uniform national framework governing use and application of electronic transactions. First enacted in California,[28] the UETA had been enacted by thirty-eight states as of May 15, 2002.[29]

The act defines the terms "record," "electronic record," and "electronic signature" and provides as a general rule that electronic records and signatures satisfy legal requirements that a record be in writing or signed.[30] The UETA also applies only to transactions between parties when each has agreed to conduct transactions by electronic means.[31] Some types of transactions will be exempt. Although the UETA is intended to have broad application, laws governing the creation and execution of wills, codicils, or testamentary trusts and, if desired by the enacting state, transactions governed by the Uniform Commercial Code (U.C.C.) or the Uniform Computer Information Transactions Act (UCITA)[32] will be excluded from the statute's affect.

The UETA contains provisions governing provision or transmission of information in electronic form, attribution of electronic records and signatures, distributing risk of error in electronic transmissions, and retention of "original" electronic records.[33] Other provisions govern automated electronic transactions or the use of so-called electronic "agents"[34] and acceptance of electronic records and signatures by governmental agencies.[35]

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26. U.C.C. § 9-314(b) (1999).

27. *See* U.C.C. § 9-105 (1999).

> A secured party has control of electronic chattel paper if the record or records comprising the chattel paper are created, stored, and assigned in such a manner that:
>
> > (1) a single authoritative copy of the record or records exists which is unique, identifiable and, except as otherwise provided in paragraphs (4), (5) and (6), unalterable;
> >
> > (2) the authoritative copy identifies the secured party as the assignee of the record or records;
> >
> > (3) the authoritative copy is communicated to and maintained by the secured party or its designated custodian;
> >
> > (4) copies or revisions that add or change an identified assignee of the authoritative copy can be made only with the participation of the secured party;
> >
> > (5) each copy of the authoritative copy and any copy of a copy is readily identifiable as a copy that is not the authoritative copy; and
> >
> > (6) any revision of the authoritative copy is readily identifiable as an authorized or unauthorized revision.

Id.

28. 2.5 Cal. Civ. § 1633.1 (1999). The California version of the UETA contains significant changes, primarily consumer protection provisions, from the UETA as adopted and applies to electronic records or signatures generated, sent, communicated, received, or stored after December 31, 2000.

29. Baker & McKenzie, *Uniform Electronic Transactions Act (UETA) State-By-State Comparison Table* (May 15, 2002), *at* http://www.bmck.com/ecommerce/uetacomp.htm.

30. UETA § 7 (1999).

31. UETA § 5 (1999).

32. UETA § 3(b) (1999).

33. UETA §§ 8-12, 15, 16 (1999).

34. UETA § 14 (1999).

35. UETA §§ 17-19 (1999).

The UETA also creates a form of electronic negotiable instrument, called a "transferable record."[36] As long as an entity has "control" of the transferable record, it is a holder of the record as defined by U.C.C. § 1-201(20) and has the same rights and defenses as a holder of a negotiable instrument or document under U.C.C. Articles 3, 7 and 9.[37] The requirements of delivery, possession and endorsement are eliminated.[38] A person has "control" over the record if "a system employed for evidencing the transfer of interests in the transferable record reliably established that person as the person to which the transferable records was issued or transferred."[39] This requirement can be met by a system that creates, stores, and assigns the transferable record in a manner that satisfies six specific conditions enumerated in the UETA.[40]

The UETA will affect the rules governing creation of enforceable contracts or instruments. Transactions existing or signed electronically, that might be unenforceable under traditional principals of law, may become enforceable when taking into account the UETA's provisions. Some commentators have also opined that the UETA could affect application of U.C.C. Article 9's priority rules to accounts.[41] Put simply, under U.C.C. Article 9 a security interest in an account[42] is perfected by filing.[43] However, a security interest in an instrument[44] is perfected only by possession.[45] The UETA § 16(a) creates the concept of "transferable record," essentially an electronic record that can qualify as a note under U.C.C. Article 3. The point is to allow electronic forms of negotiable instruments. Theoretically, an electronic communication related to an account might satisfy the rules under the UETA defining "transferable record," and thus, pursuant to the UETA § 16(d), a person having control of the communication would have the rights of a holder of a negotiable instrument under the U.C.C.. These rights include having priority over the holder of a security interest perfected solely by filing. Thus, possession of the "transferable record" would be required to properly perfect a security interest in the "account."[46]

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36. UETA § 16 (1999).

37. UETA § 16(d) (1999).

38. *Id.*

39. UETA § 16(b) (1999).

40. UETA § 16(c) (1999).

41. *See* Gerald T. McLaughlin and Neil B. Cohen, *Commercial Law: Electronic Transactions*, THE NATIONAL LAW JOURNAL, December 13, 1999, at B6.

42. Defined as "any right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper, whether or not it has been earned by performance." U.C.C. § 9-106 (1995). Revised Article 9 contains a somewhat lengthier definition, along essentially the same lines. *See* U.C.C. § 9-102(a)(2) (1999).

43. U.C.C. § 9-302(1) (1995).

44. Defined as "a negotiable instrument (defined in Section 3-104), or any other writing which evidences a right to the payment of money and. . .is of a type which is in ordinary course of business transferred by delivery with any necessary indorsement or assignment." U.C.C. § 9-105(1)(i) (1995). *See* U.C.C. § 9-102(a)(47) (1999).

45. U.C.C. §§ 9-302(1)(a), 9-305, 9-308(a), 9-309 (1995). Under the revised Article 9, security interests in instruments can be perfected by filing, but some risks may remain unless the security interest is perfected by possession. McLaughlin and Cohen, *supra* note 41.

46. McLaughlin and Cohen, *supra* note 41.

The Electronic Signatures in Global and National Commerce Act

In 2000, President Clinton signed The Electronic Signatures in Global and National Commerce Act (E-SIGN).[47] The act has two purposes: first, to make valid those contracts executed by electronic signature, and second, to protect consumers by requiring that they provide adequate consent to performing transactions electronically.

Under E-SIGN, all signatures, contracts, or other records of transaction executed in electronic form can be valid and enforceable. This means that, by itself, the fact that a signature or contract exists electronically is insufficient grounds for denial of legal effect.[48] However, E-SIGN does not require an individual to accept or use electronic records and signatures.[49]

In addition to its coverage of signatures and contracts, the act also governs "transferable records." Transferable records are electronic promises to pay money that, in paper form, would qualify as a negotiable instrument under U.C.C. Article 3, and which are related to a loan secured by real property. In short, E-SIGN allows electronic mortgage notes. E-SIGN's provisions governing transferable records are almost identical to those contained in Section 16 of the UETA. E-SIGN's provisions, unlike those of the UETA, are limited to Article 3 negotiable instruments secured by real property.[50]

A state statute or regulation can modify or supersede the act if it meets one of a few conditions. Most significantly, E-SIGN's section 101, which enables use of electronic signatures, can be modified, limited or superseded by any state statute that constitutes an enactment of the Uniform Electronic Transactions Act (UETA) in the form approved and recommended by the National Conference of Commissioners on Uniform State Laws. Any exception to the scope of the UETA included in the state statute, however, must be consistent with E-SIGN.[51] A state statue can also suggest alternative procedures and requirements for the use or acceptance of electronic signatures or records. As long as the procedures outlined do not violate any terms of E-SIGN, and do not accord greater legal status to one specific technology relating to the transmitting or authenticating of electronic signatures, E-SIGN does not preempt the state statute.

In addition, E-SIGN does not apply to a contract to the extent that it is governed by a law governing probate or family law matters,[52] a record governed by the U.C.C. (other than sections 1-107 and 1-206 and Articles 2 and 2A),[53] official court documents,[54] a Federal or state regulatory agency's right to require that records in paper form be kept if there exists a compelling governmental interest in doing so,[55] and certain consumer notices.[56]

47. 15 U.S.C. §§ 7001-7006, 7021, 7031 (2000) (hereafter *E-SIGN*).
48. E-SIGN § 101(a).
49. E-SIGN § 101(b)(2).
50. E-SIGN § 201.
51. E-SIGN § 102(a)(1).
52. E-SIGN § 103(a)(1)-(2).
53. E-SIGN § 103(a)(3).
54. E-SIGN § 103(b)(1).
55. E-SIGN § 104(b)(3)(B).
56. E-SIGN § 103(b)(2).

Electronic Transactions and the Bankruptcy Code

Electronic forms of documents and signatures are now used regularly in commerce, even in situations where a firm statutory foundation for their enforceability does not exist. This trend will accelerate with the adoption of revised U.C.C. Article 9 and UETA, and enactment of E-SIGN. In some areas, the bankruptcy code dictates different treatment for written and oral records, or requires that a document be signed. This has the potential to require different treatment for electronic records and paper records in inappropriate situations. Three sections in particular refer to written or signed documents in circumstances where electronic records or signatures are encountered.

Section 523 (a)(2)(B) – A debt for money, etc., to the extent obtained by use of a materially false statement regarding the debtor's or an insider's financial condition is only non-dischargeable if, inter alia, the statement is in "writing."

Section 546(c)(1), (d)(1) – The trustee's rights under certain provisions of the Code are subject to certain reclamation rights (such as those provided under the U.C.C.) but only if, inter alia, the seller makes a reclamation demand in "writing" within specified time limits.

Section 547 (c)(3)(A)(1) – A transfer that creates a security interest in property acquired by a debtor is not an avoidable preference to the extent it secures new value that was, inter alia, given at or after the "signing" of a security agreement that contains a description of such property as collateral.

These provisions create a danger if the terms "writing" and "signed" contained within them are interpreted to exclude electronic forms of writing or signing. Electronic forms of documents, created in most cases before the commencement of the bankruptcy case, may, outside of the bankruptcy process, be valid and enforceable. However, when viewed in light of the related bankruptcy code provisions, the efficacy of the documents in electronic form becomes subject to question.

The decision of the Court of Appeals for the Tenth Circuit in *Bellco First Federal Credit Union v. Kaspar*[57] illustrates this phenomenon. In that case, a credit card issuer interviewed a customer and obtained financial data over the telephone. The issuer's employee entered the financial data obtained into a computer database maintained by the credit card issuer. When the customer filed a bankruptcy petition, the issuer discovered the financial data provided was incorrect and filed a complaint seeking to determine the debt owed by the customer non-dischargeable pursuant to 11 U.S.C. § 523(a)(2)(B). The issuer claimed the computer database record created from the telephone comment was a "statement in writing . . . that the debtor caused to be made . . . with intent to deceive." The court held that the electronic data record could not constitute a "writing" for purposes of 11 U.S.C. § 523(a)(2)(B). This decision was based primarily on the facts of the case. The debtor had provided the information orally over the telephone and never subsequently adopted the reduction of the oral statement to writing by, for example, signing a written copy. A reading of the case shows the court's conclusion was based more on the fact that the debtor had provided the information in oral form than the question of whether

57. Bellco First Federal Credit Union v. Kaspar, 125 F.3d 1358 (10th Cir. 1997).

the computer record was or was not a "writing" for purposes of the statute. The result of the court's decision was correct since the electronic record was created by the creditor, not the debtor. However, the court's focus on the issue of whether the computer record could be a "writing," and its statement that it was not, demonstrate that the use of the term "writing" in the Code may be held to refer only to paper documents and exclude electronic documents.

E-SIGN should resolve this issue because it allows electronic signatures to satisfy writing requirements under Federal law. E-SIGN generally should override writing and signature requirements in the Bankruptcy Code. However, this may result in substituting E-SIGN's general rules governing enforceability of electronic signatures and writings in situations where, outside of the bankruptcy process, E-SIGN explicitly or implicitly defers to state or foreign law requirements. Also, E-SIGN by its terms does not apply to certain transactions to the extent governed by certain state laws. In these cases, it is unclear whether the law applicable in the bankruptcy process will be the Bankruptcy Code, E-SIGN or the applicable state law. Again, the situation can emerge where an electronic signature or record is treated differently in the bankruptcy process than outside the bankruptcy process.

Domain Names as Property Interests

Electronic contracts are not the only "new" concept bankruptcy courts must now address. Domain names, a new type of asset, have already generated a significant body of controversy and case law addressing their treatment. Two decisions show how the debate over how to characterize a domain name creates confusion when applying property law rules to domain names. Although the cases are non-bankruptcy cases, their application to issues that arise in bankruptcy cases is clear. The cases establish the ground rules for treatment of domain names in bankruptcy cases.

The U.S. District Court for the Eastern District of Virginia examined the issue of defining a domain name as a property right in *Dorer v. Arel*.[58] Faced with a plaintiff seeking sale of a domain name by sheriff's sale, the court denied the relief requested by the plaintiff. The court believed the plaintiff's intent was to effect transfer of the domain name and advised the plaintiff to use Network Solution, Inc.'s domain name dispute process to accomplish this end. In dicta, the court suggested that a domain name is not personal property subject to judicial lien, but instead represents trademark rights (to the extent the domain name holder has trademark rights in the term registered as a domain name) and contract rights (under the contract between the domain name holder and Network Solutions, Inc.). The court opined that a domain name is merely an address, and has value subject to lien only to the extent that the manner of its use adds value. The court stated "if the only value that comes from transfer of the domain name is from the value added by the user, it is inappropriate to consider that an element subject to execution."[59]

58. Dorer v. Arel, 60 F. Supp. 2d. 558 (E.D. Va. 1999).
59. *Id.*

The Virginia Supreme court reached the same conclusion in *Network Solutions, Inc. v. Umbro International, Inc.*[60] The court was asked to determine whether a sheriff could seize a domain name and sell it at a sheriff's sale to satisfy a judgment against the domain name registrant. The plaintiff had obtained a money judgment against the defendant, which had registered several domain names with Network Solutions, Inc. Although most of the domain names were not related to the plaintiff's cause of action, the plaintiff wanted them sold to raise funds to satisfy its money judgment. The lower court had viewed the defendant's domain names as personal assets subject to lien and allowed the seizure. The Virginia Supreme Court disagreed, finding that while a domain name is an intangible asset, that asset is limited to the contract rights held under the contract between the domain name holder and the registrar. The domain name holder has no separate intellectual property right in the domain name.[61]

Contrast the decision in *Umbro* with the decisions in *Caesers World, Inc. v. Caesars-Place.com*[62] and *Online Partners.com, Inc. v. Atlanticnet Media Corp.*[63] In the *Caesers World* case, the plaintiff brought an in rem action against the defendant's domain name under the newly enacted Anticybersquatting Consumer Protection Act.[64] The defendant asserted that a domain name registration is not property that can serve as res for an in rem proceeding. The U.S. District Court for the Eastern District of Virginia stated that a domain name registration was property and could serve independently as res for an *In Rem* proceeding. In the *Online Partners* case, the U.S. District Court for the Northern District of California held, in connection with an unopposed trademark infringement action, that "a domain name is intellectual property and may be attached under the law."[65] The court ordered the infringing domain name held in trust for the benefit of the plaintiff.

Originally, people treated domain names as possessing some kind of inherent intellectual property right. They assumed they could transfer the domain name freely, and renew the domain name perpetually. The lower court decision in *Umbro,* as well the decision in *Online Partners*, supported that viewpoint. Unfortunately for both creditors and domain name holders, the *Umbro* decision says that the only rights held in the domain name are the rights under the domain name contract. This means that a creditor might levy against a domain name, but be unable to sell the domain name. In this manner, the decision limits the rights of a domain name holder and thus reduces the value of the domain name.

All domain name registrars require someone registering a domain name to enter into a contract with the registrar. The terms of that contract have

60. Network Solutions, Inc. v. Umbro International, Inc., 259 Va. 759, 529 S.E.2d 80 (Va. 2000). This decision overruled the lower court decision in Umbro v. 3263851 Canada, Inc., 48 Va. Cir. 139 (Va. Cir. Ct. Feb. 3, 1999). See a*lso*, Zurakov v. Register.com, N.Y. Sup. Ct., New York Cty, No. 600703/01 (July 25, 2001)(unreported decision).

61. *Id.*

62. Caesers World, Inc. v. Caesars-Place.com, 112 F. Supp. 502 (E.D. Va. 2000).

63. Online Partners.com, Inc. v. Atlanticnet Media Corp., 2000 U.S. Dist. LEXIS 783 (N.D. Cal. 2000).

64. 15 U.S.C. § 1125(d) (2001). This amendment to the Lanham Act added an *in rem* cause of action for "bad faith" registration of domain names similar to trademarks, rendering moot the decision in Porche Cars North America, Inc. v. Porche.com, 51 F. Supp. 2d 707 (E.D. Va. 1999).

65. Online Partners, 2000 U.S. Dist. LEXIS 783 (2000)

paramount importance because they define the domain name registrant's rights to the domain name. For example, Network Solutions, Inc., now Verisign, used to take an official position that domain names are not transferable. In practice, they allowed domain name holders to effectively transfer a domain name by canceling the registration at the same time the new owner entered into a new registration contract, but nothing in Network Solutions, Inc.'s old Domain Name Service Agreement gave the domain name holder the right to transfer a domain name using this method.[66] To date, this problem has not affected the market for domain names. However, domain name holders should be concerned, and given the large number of ICANN-accredited domain name registrars, no domain name owner should use a registrar that does not contractually allow assignment of a domain name.

Despite the terms of its Domain Name Service Agreement and its actions in the *Umbro* case, Network Solutions, Inc. has cooperated in the involuntary transfer of domain names, especially through the bankruptcy process. It has fought against forced garnishment or seizure of domain names, but does not typically cancel domain names solely because of creditor collection activity. Network Solution's policy is to transfer a domain name when presented with a court order ordering transfer that is directed to the current domain name holder. It does require, however, that the parties follow its standard transfer procedures. In *In re Websecure, Inc.*,[67] for example, Gary Cruickshank auctioned the debtor's domain name, PLANETROCK.COM, using the Bid4Assets.com liquidation auction Web site. He used Network Solution, Inc.'s written Registrant Name Change Agreement to successfully complete the transfer to the successful bidder.

Consumer Information in Bankruptcy

Personal Information Collection Practices on the Internet

The Internet is making personal data a valuable business asset. Marketing professionals have long valued the ability to collect and analyze personal data about potential customers. Computers allowed processing of personal data to determine trends, identify correlation, and target potential customers, but the methods for collecting the data remained relatively limited. The Internet changed this. Visitors to Web sites provide enormous amounts of personal information, both by providing information as they register for on-line services and through systems that track their activity on the Internet. Technology companies treat this personal data as a valuable business asset. Today, some business models are built solely around collection and use of personal data - with the apparent business run as a loss leader. Because more attention is now paid to how businesses collect and use personal information, handling of personal information in a bankruptcy case has become a potential mine-field.

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66. Verisign's current agreement does provide the registrant with some transfer rights. Verisign, *Verisign Service Agreement, Version 6.3* (June 6, 2002) <http://www.netsol.com/en_US/legal/static-service-agreement.jhtml>.

67. In re Websecure, Inc., case no. 98-13316-CJK (Bankr. D. Mass. 1998)

On-line businesses collect several types of personal information. At the most basic level, they collect the same type of customer information as any off-line business, such as a customer's name, address, telephone number and purchase history. As in the off-line world, the business only collects this information when the customer provides it. But on-line businesses also collect information without the customer's knowledge. For example, many websites glean information about a visitor's computer and the visitor's activity on the website. The company uses this kind of information to customize the website to the visitor's needs and evaluate how well its website works. On-line businesses may also trade this information with its partners. For example, the Internet advertisement placement company DoubleClick was criticized for attempting to track Internet users' activities on collect data from its customers for the purpose of targeting advertisements to Internet users.[68] In the extreme, an Internet business can collect data about who you are and link it with information about what you do while using the Internet.

Concern over collection and use of personal information over the Internet is resulting in new information collection practices. New statutes restrict companies' ability to collect and use personal data in specific situations. In 1998, Congress enacted the Children's Online Privacy Protection Act (COPPA)[69] to regulate collection of personal data by commercial websites that are targeted at children or that have actual knowledge that information is being collected from a child.[70] COPPA's provisions prohibit most collection of personal information from children unless the company first obtains verifiable parental consent. Even when consent is obtained, COPPA limits what data can be collected and how it can be used.[71]

Other Federal statutes govern collection and use of personal data in specific industries. The Fair Credit Reporting Act (FCRA) may apply to on-line businesses that regularly collect and distribute to third parties personal financial information for credit or insurance underwriting or employment decisions.[72] The Gramm-Leach-Bliley Act of 1999,[73] and rules promulgated under that act by Federal agencies like the FTC, control use of consumer data by financial institutions and govern their on-line privacy policies. Also relevant is the Health Insurance Portability and Accountability Act of 1996 (HIPAA).[74] HIPAA includes provisions requiring security procedures for electronic medical records.[75]

Among on-line businesses, the trend is toward greater regulation of personal data. The Federal Trade Commission and consumer protection groups

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68. Chet Dembeck & Robert Conlin, *Beleaguered DoubleClick Appoints Privacy Board*, E-COMMERCE TIMES (May 17, 2000), *at* http://www.ecommercetimes.com/perl/story/3348.html.

69. 15 U.S.C. §§ 6501-6506 (1994 & Supp. 1998).

70. The term "child" is defined for purposes of the act as a person under 13 years of age. 15 U.S.C. § 6501(1).

71. Scott Killingsworth, *Minding Your Own Business: Privacy Policies in Principle and in Practice*, 7 J. INTELL. PROP. L. 57, 73 (1999).

72. *Id.* at 76.

73. 15 U.S.C. §§ 6801-6809 (1994 & Supp. 1999).

74. 42 U.S.C. § 1320d (1994 & Supp. 1996).

75. Richard D. Marks, *Guidelines for Initiating HIPAA Systems Implementation Projects*, ELECTRONIC COMMERCE & LAW REPORT, Vol. 5, No. 18, 468-74 (May 3, 2000).

encourage companies to self-regulate by adopting "privacy policies."[76] A privacy policy discloses an on-line business' data collection and use practices. The typical privacy policy does five things. First, it gives customers notice of what data the website collects and how the company uses the data. Second, it gives the customer a choice to "opt-out" of certain data uses. For example, a customer might be allowed to ask that the company not e-mail promotional materials about new products. Third, the company gives the customer access to his information and the ability to update or correct personal information. Fourth, the privacy policy will describe what steps the company takes to keep the personal information secure. Fifth, the company provides a mechanism to allow customers to enforce the privacy policy.[77]

Some online companies contract with outside vendors like TRUSTe[78] or the Better Business Bureau Online[79] to review and validate their privacy policies. These companies will, assuming a website has an adequate privacy policy, let the company display a seal of approval. However, these companies will also provide an enforcement mechanism for consumers, creating a risk for the website that does not take its privacy policy seriously.

Personal Information as an Asset: Treatment in the Bankruptcy Process

How collected personal data passes through the bankruptcy process will become an issue for future cases.[80] Currently, few rights attach to corporate use of personal data, and what rights do exist are provided solely by statute. A business that collects data can use the data how it likes.[81] In the traditional framework, a company in bankruptcy can use customer data without restriction. It also can sell the data freely, either as part of the entire business, or separately. In some cases, the customer data is one of the most valuable assets.

Companies, by using privacy policies, theoretically limit their rights to customer information. This became very clear in the *In re Toysmart.com, LLC*[82] Chapter 11 case. Toysmart operated an on-line toy store that ran into financial trouble and ceased operations in May 2000. After its creditors filed an involuntary Chapter 11 case against it, Toysmart filed a motion to conduct a public auction of several assets, including its customer data. Toysmart had, in 1999, adopted a privacy policy and became a licensee of TRUSTe. On learning about the proposed sale of personal information, TRUSTe complained to the Federal Trade Commission (FTC) that the proposed sale would violate Toysmart's privacy policy. The FTC sued Toysmart in Federal District Court alleging that the sale of data was an unfair or deceptive business practice violating the FTC Act,[83] and requesting that the court enjoin the sale.[84] While

76. More information about FTC initiatives in on-line privacy is available at Federal Trade Commission, see *Privacy Initiatives* (April 23, 2002), *at* www.ftc.gov/privacy/index.html.

77. *Id.* at 88-91.

78. *See generally* TRUSTe, *at* http://www.truste.com.

79. *See generally* BBB Online, *at* http://www.bbbonline.org.

80. Jane K. Winn and James Wrathall, *Who Owns the Customer? The Emerging Law of Commercial Transactions in Electronic Customer Data*, 56 BUS. LAW. 213 (November 2000). *See also*, Warren E. Agin, *The New Regime for Treatment of Customer Data in Bankruptcy Cases*, 10 J. BANKR. LAW & PRAC. 365 (2001).

81. There are some exceptions, the most notable being medical and financial data.

82. In re Toysmart.com, LLC, No. 00-13995-CJK, (Bankr. D. Mass. 2000).

83. 15 U.S.C. § 45(a) (1994). Presumably, the FTC relied upon the police and regulatory power exception

Toysmart settled its issues with the FTC,[85] several states' attorneys generals filed objections to the sale with the bankruptcy court. The controversy limited Toysmart's ability to obtain significant bids and, in the face of the objections, Toysmart withdrew the customer data from auction.

The *Toysmart* case raises the question of what exactly is a privacy policy. A privacy policy might be considered a contract between the customer and the company. In this case, would the contact be treated as executory?[86] Whether a privacy statement is executory or non-executory will depend on its terms, primarily whether it places continuing material obligations on the customer. The company will always have a continuing obligation to use and maintain data according to the policy's terms. Assuming the privacy policy is executory, a company desiring to retain customer data would have to assume the privacy policy and continue to abide by its terms. Could a company that files a bankruptcy petition breach the use restrictions by transferring the data in violation of the contract, reject the contract, and leave individuals with general unsecured claims? Most likely, a debtor rejecting a privacy policy would have to relinquish rights to data collected under the policy.

A non-executory privacy policy would grant customers fewer rights. A debtor could breach the non-executory policy, and the customer's rights could be limited to a general unsecured claim. Possibly, a court might grant the customer the right to equitable relief against the debtor to prevent misuse of the provided information. However, a privacy policy might not even qualify as an enforceable contract. One court has already stated that an on-line contract is not enforceable unless its terms are obvious and apparent, and that making the contract accessible only through a link at the bottom of a Web page does not qualify.[87] Under this test, most privacy policies do not rise to the level of mutually enforceable contracts. In most cases, companies do not conspicuously display their privacy policy. A customer wanting to view the privacy policy must find and click on a small link at the bottom of a Web page.

Customers might enforce a non-contractual privacy policy based on the doctrine of unjust enrichment. Another option is to claim that use of the information in violation of the privacy policy constitutes an unfair or deceptive business practice. Many states have statutes, known as "little-FTC Acts," which give consumers a private cause of action to enjoin unfair or deceptive business practices. A privacy regime would give a third option, giving the individual a statutory or judicially created right to control personal data. This right would be similar to the rights granted a patent or copyright holder. Privacy rights in personal data would give individuals significant control over the data - businesses could only use what rights they contract for, and these rights probably will not be transferable in bankruptcy without the individual's affirmative consent.[88]

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to the automatic stay in filing the civil complaint. 11 U.S.C. § 362(b)(4) (1978).

84. FTC v. Toysmart.com, LLC, No. 00-11341-RGS (D. Mass. filed Aug. 10, 2000).

85. The settlement was subject to bankruptcy court approval.

86. Executory contracts are governed by 11 U.S.C. § 365 (1978).

87. *Ticketmaster v. Tickets.com*, 54 U.S.P.Q.2d 1344, 2000 U.S. Dist. LEXIS 4553 (C.D. Cal. 2000).

88. 11 U.S.C. § 365(c)(1)(A) (1978).

These issues, enforcement of electronic signatures and contracts, ownership rights in domain names and transfer of customer information, give practitioners new things to think about when evaluating the effect of a bankruptcy filing on a company. But, the driving issues in a bankruptcy case often depend on treatment of lenders. Beyond the new issues the Internet raises, new issues are arising in how a secured lender is treated in a technology case.

COLLATERALIZING INTELLECTUAL PROPERTY

Perfection of Security Interests in Copyrights

One goal of commercial law is to provide lenders ease and certainty in perfecting security interests in property. Article 9 of the Uniform Commercial Code (Article 9) accomplishes this goal by allowing perfection against most assets by filing a simple document with a centralized registry. Easily obtained security interests simplify lending and open capital sources. The Bankruptcy Code is designed to recognize secured creditor's rights when they comply with the applicable rules, and balance those rights against the needs of the debtor and other creditors.

The Peregrine Case

The carefully constructed rules cease working when applied to security interests in copyrights because of a provision in the U.S. Copyright Act[89] and a California District Court decision, *In re Peregrine Entertainment, Ltd.*[90] The U.S. District Court for the Central District of California addressed a creditor's claim that it had properly perfected its lien on a film library by filing a U.C.C.-1 financing statement in accordance with the provisions of Article 9. The court held that the U.S. Copyright Act preempted the Article 9 perfection provisions and therefore filing with the Copyright Office was required to perfect a security interest in a copyright.

The court's conclusion flows naturally from provisions of the Copyright Act and Article 9. Section 205(a) of the Copyright Act provides that "any transfer of copyright ownership or other document pertaining to a copyright may be recorded in the Copyright Office" and Section 205(c) provides that recording any such document in connection with a registered copyright gives all persons constructive notice of the facts stated in the recorded document. The Copyright Act defines the term "transfer of copyright ownership" to include "an assignment, mortgage, exclusive license, or any other conveyance, alienation, or hypothecation of a copyright."[91] This definition clearly encompasses security interests in copyrights.

The U.C.C., because it is enacted as a state statute, is subject to preemption by Federal statutes. U.C.C. Article 9 recognizes this and provides two "step-back" provisions. The first, found in section 9-109(c)(1), states "this article

89. Title 17 of the U.S. Code.
90. In re Peregrine Entertainment, Ltd., 116 B.R. 194 (C.D. Cal. 1990).
91. 17 U.S.C. § 101 (1998).

does not apply to the extent that . . . a statute, regulation, or treaty of the United States preempts this article. . . ."[92] The second, found at section 9-311(a)(1), says, "the filing of a financing statement is not necessary or effective to perfect a security interest in property subject to . . . a statute, regulation, or treaty of the United States whose requirements for a security interest's obtaining priority over the rights of a lien creditor with respect to the property preempt Section 9-310(a)"[93] These provisions differ somewhat from the step-back provisions in old Article 9 — relevant in that old Article 9 applied to the dispute in *Peregrine*. U.C.C. § 9-104(a) provided that Article 9 does not apply to a security interest subject to a Federal statute "to the extent that such statute governs the rights of parties to and third parties affected by transactions in particular types of property."[94] Section 9-302(3)(a) stated that a U.C.C.-1 Financing Statement is not necessary to perfect a security interest in property subject to any statute or treaty of the United States which provides for national or international registration or which specifies a place for filing a security interest.[95] The provisions of Section 205 of the Copyright Act appear to satisfy the requirements for federal preemption of Article 9.

The decision in *Peregrine*, and the later, but similar, decision in *In re AEG Acquisition Corp*.,[96] applied to security interests in registered copyrights. Thus, their direct impact was limited to intellectual property assets that are easily defined and determined. Registered copyrights are relatively easy to identify through the U.S. Copyright Office's records and due diligence. Further, in the context of the entertainment industry (the subject of *Peregrine*) lenders want to secure with respect to a specific asset, usually a film or other artistic work, without regard to ownership. The perfection structure dictated by *Peregrine* serves this need. Copyrights in these works are always registered and the U.S. Copyright Office provides a central filing location.

The Avalon Case

The *Peregrine* structure does not work when applied to the software industry, as demonstrated by the U.S. Bankruptcy Court for the District of Arizona's decision in *In re Avalon Software*, *Inc*.[97] That court held a creditor does not have a perfected security interest in property subject to protection under the Copyright Act, unless (1) the debtor has registered its copyright in the property, and (2) the creditor files its security interest with the U.S. Copyright Office. Thus, the *Avalon* decision extends the *Peregrine* decision to unregistered copyrights.

In 1994, Avalon Software, Inc, a computer software developer, obtained a loan from Imperial Bank. Avalon granted Imperial a security interest in all its assets, then or after acquired, including accounts, general intangibles, equipment, inventory and proceeds. Imperial filed a U.C.C.-1 financing statement with the Arizona Secretary of State, thus satisfying the perfection

92. U.C.C. § 9-109(c)(1) (1999).
93. U.C.C. § 9-311(a)(1) (1999).
94. U.C.C. § 9-104(a) (1995).
95. U.C.C. § 9-302(3)(a) (1995).
96. In re AEG Acquisition Corp., 127 B.R. 34 (Bankr. C.D. Cal. 1991).
97. In re Avalon Software, Inc., 209 B.R. 517 (Bankr. D. Ariz. 1997).

requirements of Article 9 as enacted in Arizona. At that time, Avalon had registered with the Copyright Office copyrights in software developed between 1989 and 1991. However, after 1991, Avalon did not register copyrights in its software. Imperial did not file any documents providing notice of its security interest with the Copyright Office. After 1994, Avalon continued to produce new software programs. It also created updates, modifications, amendments and enhancements to its existing software programs. Avalon did not register a copyright in any of these works. Avalon subsequently filed a chapter 11 petition and substantially all of its assets were sold, with court approval, to a third party. Imperial's lien attached to the sale proceeds.

The debtor and the creditor's committee sought to avoid Imperial's lien against the proceeds from the sale of Avalon's software and software licenses. Judge Marlar, following the *Peregrine* and *AEG Acquisition* decisions, held that Imperial's failure to file its security interest with the U.S. Copyright Officer meant its lien was unperfected as against all Avalon's software related assets, including the proceeds from selling those assets. A product susceptible to copyright protection acquires its character as "copyrightable" when the intellectual work is created.[98] A work can receive copyright protection even if the copyright is not registered. Thus, the court concluded, regardless of whether the copyright in the work is registered, a lien in the copyright can only be perfected by filing a security agreement with the Copyright Office. Based on this argument, the bankruptcy court held that Imperial's lien was unperfected against Avalon's software, even the copyrightable software that had not been registered with the Copyright Office. The lack of perfection extended to software that was a modification, enhancement or offshoot of the existing programs, and also extended to Avalon's rights under licenses of the software rights.

The court in *Avalon* took rules that worked when applied to the entertainment industry and applied them to a software company. In the entertainment industry, copyrights in finished works are always registered. Lending is project based, not entity based. In the software industry, copyright registration is less often used, especially since copyright registration of software code is inconsistent with the concept of using trade secret laws to protect source code. Also, copyright protection is available for a broad variety of assets, for which registered copyright protection is not sought. Marketing materials, brochures, instruction manuals, internal correspondence, accounting and business records, white papers, advertising copy and graphics, logos, artwork, and even buildings are all examples of common business assets subject to copyright protection. As a business matter, registering a copyright in all such assets is impractical and expensive. Further, registering a copyright in some types of copyrightable assets, such as intellectual property works in progress, is not possible, because registering a copyright requires making a deposit of the work. Imagine filing as a public record a copy of a Web site for a product that is not yet launched.

The *Avalon* decision also creates a problem with respect to after-acquired property. Maintaining the security interest against after-acquired or derivative

98. 17 U.S.C. §§101, 201(a) (1998).

works becomes more difficult because the security agreement filed with the Copyright Office must reference each individual copyright registration. Thus, as new works are created and old works are revised, the lender and borrower must file a continuous stream of copyright registrations and security agreements.

Perhaps the *Avalon* decision's greatest problem is its failure to recognize that while a debtor can have a copyright in a work, the copyright is not the work. For example, software consists of tangible media, trade secret rights, license rights, trademark rights, and patent rights. Even if the court held that Imperial's lien against Avalon's copyrights in its software was unperfected, that is not the same as holding that Imperial's lien against the software was unperfected. Even following the decisions of the courts in *Peregrine* and *AEG Aqcuisitions*, courts need to develop methods for determining the value that is attributable to the copyright in a work, and the value of the work attributable to other factors. This calculation will differ on a case by case basis. The approach taken by the court in *Avalon*, determining that the lender's failure to perfect its lien in copyrights in the software obviated any lien it had in the software itself, simply misapplies copyright law, confusing a personal right in an aspect of a property asset with the property asset itself.

A subsequent case out of the U.S. Bankruptcy Court for the Northern District of California, *Aerocon Engineering, Inc. v. Silicon Valley Bank*,[99] approached the problem with a more limited approach than the court in *Avalon*. The court in *Aerocon* limited the *Peregrine* preemption principal to copyrights registered under the U.S. Copyright Act, thus reaching a more commercially reasonable result.

Perfection of Security Interests in Patents

Patents, governed by the federal Patent Act,[100] play an important role in high technology businesses. As with copyrights, lenders and bankruptcy trustees have litigated the question of whether, to perfect a security interest in a patent, the lender must file its financing statement with the appropriate state agency under U.C.C. Article 9 or with U.S. Patent & Trademark Office (PTO). The U.S. Court of Appeals for the Ninth Circuit decision in *Moldo v. Matsco*[101] not only confirmed that a secured creditor should file under state law to perfect a security interest in a patent, but also provides new insights into the unusual nature of patents.

The Patent Act provides for recordation of patents with the PTO. Section 261 of the Patent Act provides that "an *assignment, grant or conveyance* shall be void as against any subsequent *purchaser or* mortgagee for valuable consideration without notice unless it is recorded in the Patent and Trademark Office within three months from its date or prior to the date of such subsequent purchase or mortgage."[102] This provision could, theoretically, preempt the

99. Aerocon Engineering, Inc. v. Silicon Valley Bank, 244 B.R. 149 (Bankr. N.D. Cal. 1999). The decision is currently on appeal to the Court of Appeals for the Ninth Circuit.

100. Title 35 of the United States Code.

101. Moldo v. Matsco, 252 F.3d 1039 (9th Cir. 2001).

102. 35 U.S.C. § 261 (1952) (emphasis added).

Article 9 filing requirements, especially given the wording of the old Article 9 step-back provisions.

As a result of the Patent Act's possible preemption of Article 9, bankruptcy trustees have argued that a lender must file a security interest with the PTO in order to perfect its security interest against the bankruptcy trustee. When the secured lender merely files a financing statement with the Secretary of State, the patent might belong to the bankruptcy trustee.

In *Maldo*, Matsco, Inc. and Matsco Financial Corporation had a security interest in a patent, held by Cybernetic Services, Inc., for a data recorder designed to capture data from a video signal. Matsco filed a financing statement with the California Secretary of State in conformance with the California enactment of the Uniform Commercial Code, but did not file a copy of the security agreement with the PTO. Subsequently, creditors filed an involuntary Chapter 7 petition against Cybernetic Services, Inc. When Matsco sought relief from stay from the bankruptcy court to foreclose its security interest in the patent, the Chapter 7 bankruptcy trustee objected, arguing that Matsco had failed to perfect its security interest because it had not filed with the PTO.[103]

Prior cases, such as *In re Transportation Design & Technology Inc*.[104] and *Chesapeake Fiber Packaging Corp. v. Sebro Packaging Corp.*,[105] addressed the issue by examining the nature of the PTO filing system and the question of whether a lien creditor, including a bankruptcy trustee by virtue of the Strong-Arm statute,[106] qualified as a "subsequent purchaser or mortgagee" for purposes of the Patent Act. These cases concluded that a lien creditor is neither a "subsequent purchaser or mortgagee." While filing a security interest with the PTO might provide notice effective to obtain priority status as against a subsequent purchaser or mortgagee, it would not affect the filer's status as against a lien creditor or bankruptcy trustee. Thus, the Patent Act does not preempt Article 9's perfection scheme because it was not intended to provide a Federal filing system for security interests in patents that would replace Article 9's filing scheme. The secured creditor protects itself against bankruptcy trustees by filing a financing statement under Article 9.

The court in *Moldo v. Matsco* reached the same conclusion, but took a slightly different approach in a key section of the decision. The court noted that the Patent Act filing provision addresses the priority treatment of an "assignment, grant or conveyance." After a lengthy discussion of the historical legal background against which Congress drafted the Patent Act, the court noted that the terms "assignment, grant or conveyance" have unique meanings when applied to patents. A patent "assignment" is a transfer of a patent holder's undivided interest in the patent. A "grant" is an assignment with respect to a limited geographic region. The term "conveyance," while not as clearly defined by decisional law, can apply only to a transfer of a title interest. A security interest does not meet these criteria and, therefore, is neither an assignment, grant, nor conveyance. So, the Patent Act provisions governing priority of

103. Moldo v. Matsco, 252 F.3d 1039 (9th Cir. 2001).
104. In re Transportation Design & Technology Inc., 48 B.R. 635 (Bankr. S.D. Cal. 1985).
105. Chesapeake Fiber Packaging Corp. v. Sebro Packaging Corp., 143 B.R. 360 (Bankr. D. Md. 1992).
106. 11 U.S.C. § 544(a) (1978).

interests, which apply only to the effect of filing an assignment, grant or conveyance, do not apply to the filing of a security interest. Not only, stated the court, does a lender not have to file a security interest with the PTO to obtain priority over subsequent mortgagees and purchasers, but filing the security interest with the PTO is wholly ineffective in obtaining that priority. In all circumstances, Article 9 governs how a lender obtains priority over third parties. A lender, or other creditor, does not have to file with the PTO to establish rights against a patent.[107]

Security Interests in Licenses under Revised Article 9

While decisions like that in *Peregrine* create uncertainty for lenders seeking copyrights as collateral, the new U.C.C. Article 9 provides the same lenders with greater certainty when using copyright licenses as collateral. Under old Article 9, lenders never quite knew whether license terms restricting assignment, or terminating the license on encumbrance, were enforceable against the lender. Section 408 of revised U.C.C. Article 9 changes the rules governing treatment of security interests in licenses and other general intangibles. The new rules, while not exactly granting lenders a blank check, do provide more guidance than previously.

Terms contained in a document creating a general intangible, including a software or copyright license, which prohibit, restrict, or require consent for creation, attachment, or perfection of a security interest in the general intangible will be ineffective to the extent the terms:

1. would impair the creation, attachment, or perfection of a security interest; or
2. provide that the creation, attachment or perfection of the security interest may give rise to a default under the license.[108]

Similar provisions contained in a statute or governmental rule or regulation are similarly ineffective.[109] However, all is not well for the secured creditor. To the extent a term or statute restricting creation, attachment or perfection of a security interest would be effective outside of Article 9, the creation, attachment, or perfection of a security interest in the general intangible:

1. is not enforceable against, or impose a duty on, the other party to the general intangible agreement;
2. does not require the other party to the general intangible agreement to recognize the security interest, provide performance to the secured party, or accept performance from the secured party;
3. does not entitle the secured party to use or assign the debtor's rights under the general intangible, including any related information or materials furnished to the debtor in the transaction giving rise to the general intangible agreement;
4. does not entitle the secured party to use, assign, possess, or have access to any trade secrets or confidential information of the other party to the general intangible agreement; and

107. Moldo v. Matsco, 252 F.3d 1039 (2001).
108. U.C.C. § 9-408(a) (1999).
109. U.C.C. § 9-408(c) (1999).

5. does not entitle the secured party to enforce the security interest in the general intangible.[110]

This means the secured party can obtain a security interest, but can not enforce it. For example, a lender seeking a security interest in the licensee's rights under a software license can obtain that security interest. The lender can not, in the face of a term in the license restricting assignment, enforce its security interest against the license. What the lender can do is enforce a security interest against proceeds from any disposition of the license rights, assuming it had the foresight to obtain and perfect a security interest in the proceeds. However, even in bankruptcy, restrictions on the borrower's ability to sell that license can drastically effect the lender's ability to recover value.

INTELLECTUAL PROPERTY LICENSES AND SECTION 365

The Bankruptcy Code recognizes that a reorganizing debtor must have the ability to hold third parties to existing contractual obligations where beneficial to the estate, and even transfer the contractual obligations to third parties. Section 365 of the Code grants the debtor the ability to assume and assign such executory contracts.[111] The debtor's ability to assume and assign a contract is not absolute. The Code recognizes that in some circumstances allowing a debtor to assign a contract to a third party creates too great an imposition on the other party to the contract. Rather than define the specific instances when a contract may not be assigned, section 365 (c)(1)(A) restricts assignment when non-bankruptcy laws (but not contractual terms) excuse the non-debtor party to the contract from accepting performance from an assignee.[112] Thus, the Code looks to other law, either statutory or judicial, to determine when forced assignment of contract rights is too unfair to the non-debtor party to be allowed.

Assignment by a Patent Licensee

In the *Everex Systems, Inc. v. Cadtrak Corporation*[113] case, the U.S. Court of Appeals for the Ninth Circuit sustained a licensor's objection to a debtor assigning its rights under a non-exclusive patent license. The decision focused on the language of section 365 (c)(1)(A). The relevant applicable law was the Federal common law principal that non-exclusive patent licenses contain an implied term restricting assignment.[114]

The decision in *Everex* stems from an important distinction between a license and a contract. A contract is an agreement between parties defining mutual obligations to each other. A license is an agreement by the holder of intellectual property rights to allow a third party to violate those intellectual property rights. A license is sometimes described as an agreement not to sue. Intellectual property rights are generally considered personal to the owner. For

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110. U.C.C. § 9-408(d) (1999).
111. 11 U.S.C. § 365 (1978).
112. 11 U.S.C. § 365(c)(1)(A) (1978).
113. Everex Systems, Inc. v. Cadtrak Corp., 89 F.3d 673, 679-80 (9th Cir. 1996).
114. *See, e.g.*, Commissioner v. Sunnen, 333 U.S. 591, 609 (1948).

example, a patent is considered a personal right of the inventor (although patent rights can be assigned). As a personal right, patent law recognizes a strengthened right of the patent holder to control who uses or, more accurately stated, who is allowed to violate the patent. This translates into a recognized right to control the terms, and recipient, of any license of the patent rights. The *Everex* decision rests on this principle.

The decision in *Everex* has a potentially chilling effect on reorganizations. It grants a patent licensor undue control over a licensee's reorganization, especially if that reorganization requires a sale or transfer of assets. In some cases, allowing forced assignment of a patent license will cause severe problems for the licensor (although such situations can be avoided through proper drafting of the patent license). However, in many other cases involving technology companies the patent license rights are essential to the debtor's operation and the debtor must retain the rights for it, or its successor, to continue operations. In some of these cases, the cost to the patent licensor of forced assignment is, at most, loss of a relatively small amount of revenue. Patent licenses also occur within relationships that do not fall within the scope of the standard technology transfer. For example, many software licenses include a patent license component.

Assumption by a Patent Licensee

By extension, the *Everex* holding prevents not only assignment of patent license rights but mere assumption by a reorganizing debtor. Code section 365(c) uses the language "the trustee may not assume or assign any executory contract or unexpired lease of the debtor . . . ."[115] One line of cases has adopted a "hypothetical test" in interpreting the use of the word "or" in section 365(c), holding the section restricts assignment of an executory contract when a hypothetical assignment would be prohibited.[116] Another line of cases concludes that restricting assumption merely because applicable law prohibits assignment is nonsensical and applies an "actual test" holding that section 365(c) limits assumption only when the trustee intends to subsequently assign the assumed contract.[117] In *In re Catapult Entertainment,*[118] the U.S. Court of Appeals for the Ninth Circuit adopted the hypothetical test in the context of assumption of a patent license, and held a debtor could not assume rights under a non-exclusive patent license over the licensor's objection.[119]

The Catapult decision expands the *Everex* decision's impact and gives patent licensors veto power over a debtor's ability to retain license rights after reorganization. While granting a licensor control over assignment of the licensee's interest is backed by existing public policy considerations, allowing

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115. 11 U.S.C. § 365(c) (1978).

116. *See generally* In re Catapult Entertainment, 165 F.3d 747 (9th Cir. 1999), In re James Cable Partners, 27 F.3d 534 (11th Cir. 1994), In re Writ Electric, Inc. 852 F.2d 79 (3rd Cir. 1988), In re Catron, 158 B.R. 629 (E.D. Va. 1993).

117. *See* Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489 (1st Cir. 1997).

118. In re Catapult Entertainment, 165 F.3d. 747 (1999).

119. *See also,* In re Access Beyond Technologies, Inc., 237 B.R. 32 (Bankr. D. Del. 1999). However, in *Institut Pasteur,* the Court of Appeals for the First Circuit applied the actual test and allowed a debtor to circumvent the *Everex* prohibition on assignment by assuming the rights under a patent license and then transferring the equity interest in the entity that had assumed the license.

a patent licensor the ability to terminate the license merely because the licensee has filed a bankruptcy runs contrary to the bankruptcy policy against ipso facto clauses in contracts.

Assignment by a Copyright Licensee

The restrictions on assumption and assignment of patent licenses may also apply to assumption and assignment of a licensee's rights under a non-exclusive copyright license. In *Emmylou Harris v. Emus Records Corp.*,[120] the U.S. Court of Appeals for the Ninth Circuit applied the concepts later expressed in the *Everex* decision to a copyright license, stating that the bankrupt licensee of rights under a mechanical recording license could not assign those rights to a third party because the rights were personal in nature. Although the *Emmylou Harris* case was decided under the Bankruptcy Act, the holding was, in *In re Patient Education Media, Inc.*,[121] applied to bar assignment under the Bankruptcy Code of a non-exclusive copyright license to reproduce photographs.

The decisions in the *Emmylou Harris* and *Patient Education* cases go beyond assignment of recording contracts and photograph reproduction rights. The principles espoused in the cases apply, theoretically, to the entire field of copyrights since they are based in the concept of what a copyright is, not what type of copyrighted material is at issue. Judge Bernstein's decision in *Patient Education* described the Copyright Act as "intended to motivate the creative activity of authors and inventors by the provision of a special reward."[122] This "reward" is the right to control transfer and use of the copyrighted works.

In the context of a recorded song or an artistic photograph, protecting the artist's right to control his work seems reasonable. Protecting this right seems less reasonable in the context of copyrightable material produced for commercial purposes, such as software, Web sites, marketing materials, and commercial graphics. For example, if an advertising agency designs a brochure cover but does not sign a written copyright assignment the advertising agency retains the copyrights in the brochure cover. Should the advertising agency have the right to prevent its client from using the brochure cover post-bankruptcy? Imagine a .com business that hires a design firm to produce and manage its Web site, but fails to include a copyright assignment in the design contract. Should the .com be forced to abandon its entire Web site just because it passes through a bankruptcy case? These are the results dictated by the decisions in the *Emmylou Harris* and *Patient Education* cases.

CONCLUSION

The above, being only a few of the new issues arising in bankruptcy cases, show the problems that arise at the intersection of two, largely inconsistent, bodies of law. On the one hand, intellectual property law concepts govern the

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120. Emmylou Harris v. Emus Records Corp., 734 F.2d 1329 (9th Cir. 1984).

121. In re Patient Education Media, Inc., 210 B.R. 237 (Bankr. S.D.N.Y. 1997), *also*, In re Golden Books Family Ent., Inc., 269 B.R. 300 (Bankr. D. Del. 2001).

122. Patient Education Media, 210 B.R. at 240 (*quoting* Sony Corp. of America v. Universal City Studios, Inc., 464 U.S. 417, 429 (1984)).

ephemeral world of creativity and ideas. On the other hand, commercial law governs concrete business transactions. Cutting across the intersection is the concept of things electronic, such as electronic signatures, data, and software. Both tangible and intangible in form, things electronic are as hard to define as they sometimes are to understand. To find cohesive answers to the questions that will arise, the courts and practitioners need to better understand this new electronic world and work to craft solutions that accommodate the needs of both intellectual property and commercial law. Many of these solutions will develop through the bankruptcy process.

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