Expert Q&A on Artificial Intelligence and Bankruptcy

PRACTICAL LAW BANKRUPTCY

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An Expert Q&A with Janet M. Weiss of Dorsey & Whitney LLP discussing her views on the legal protections available for artificial intelligence and the potential treatment of artificial intelligence licenses in bankruptcy.

Artificial intelligence (AI) is a term used to describe computer technology that simulates human intelligence to analyze data so that it can:

- Reach conclusions.
- Make informed judgments.
- Recognize patterns.
- Predict future behavior.

The technology uses algorithms to learn responses to new input by collecting and analyzing the data, including past responses created by use of the software. AI is already being used in many ways in homes and businesses. For example, in the home, voice-activated devices like the Amazon Echo and Google Home can organize a consumer's schedule, create and play a consumer's music playlist, or control other smart home devices. Another example is smart phone technology that suggests words based on inputting a few letters and predicting the word the user intends to spell determined by an algorithm analyzing frequently used words.

AI is one of several areas of digital innovation that is developing increasingly rapidly and where the legal consequences are challenging to foresee. The considerable and continued growth of AI technology is likely to provide a significant impulse for developments in intellectual property (IP) law. As IP law evolves and advances to protect AI, the rights and interests of licensors and licensees are likely to be impacted both in and out of bankruptcy.

Practical Law asked Janet M. Weiss of Dorsey & Whitney LLP to discuss her views on the legal protections available for AI and the potential treatment of AI licenses in bankruptcy.

HOW CAN AI BE USED TO ASSIST THE PRACTICE OF LAW?

Innovative legal departments and law firms are using AI to automate a variety of time consuming and repetitive tasks, including:

- E-discovery.
- Contract review and analysis, including performing due diligence for a variety of corporate transactions.
- Legal research.
- Developing litigation strategy.
- Predicting which companies are likely to file bankruptcy cases.

By using AI in the practice of law, attorneys can:

- Become more efficient at performing legal tasks involving large data sets.
- Make data-driven decisions.
- Save costs on outside counsel and other alternative legal service providers.
- Foster increased collaboration with outside counsel.
- Reduce risk because AI helps with the review of large data sets, and not just sub-sets of available data.

For more information, see Article, Use of Artificial Intelligence within the Legal Industry (W-012-1157).

HOW DO AI DEVELOPERS PROTECT NEW DEVELOPMENTS?

Patents provide the primary legal protection for AI software developers. The grant of a patent protects developers by empowering them to prevent other parties from using the new technology. The AI software developer therefore has the exclusive right to control the use of the technology for a limited period of time. In exchange, the AI software developer must sufficiently disclose the technology to enable competitors to recreate the technology after the patent protection period expires. Copyrights also provide protection for AI software, but only for the unique formulation of source code.

Neither patents nor copyrights protect abstract ideas. Because abstract ideas, laws of nature, and natural phenomenon "are basic

tools of scientific and technological work," the US Supreme Court expressed concern that monopolizing these tools by granting patent or copyright protection may impede, rather than promote innovation (see *Alice Corp. Pty. Ltd. v. CLS Bank Int'l*, 134 S. Ct. 2347 (2014)). The law is somewhat subjective regarding which inventions may be patented and which ones cannot because they represent abstract ideas, which creates challenges for applicants seeking patents in software.

A complicating factor in protecting AI software also lies in the fact that patent and copyright law have not kept pace with new issues created by the rapid AI advances. As AI technology continues to advance, several issues arise regarding protection of AI under patent or copyright law, including that:

- Neither patents nor copyrights fully protect both the source code and the functionality of the software:
  - copyrights extend protection to the original expression of the source code, but not to the methodology by which software achieves its functionality, such as algorithms, formatting, and output results; and
  - patents protect some aspects of AI, including some portions of the source code and hardware components used in the AI system, but not abstract ideas.
- Protection granted by both copyrights and patents is based on the identity of the person creating the relevant section of code, which creates a problem when trying to protect the large portions of source code generated automatically by the AI software (AI software uses results obtained by on-going use of the software to create new source code).
- AI software is frequently built using multiple open software resources. While open source software can generally be freely used, the ability to exclude others from using or licensing the open source code is not uniform. Some open source code prevents users from protecting new technology incorporating the open source code. Therefore, the ability to protect AI software may depend on the restrictions contained and incorporated in the open source code embedded in the software.
- Large sources of data are required for AI software to function and data is often collected and formatted by third party providers. The data providers may restrict new technology incorporating this data from receiving patent protection.
- Patents can take three to five years to obtain. During this period, rapid developments in the field can create new issues that the patent application did not address.

Treating AI programs as trade secrets may offer an alternative to employing patent and copyright law. Trade secrets generally receive legal protection based on a two-part system:

- The owner of the trade secret must take reasonable steps to protect the trade secrets, such as:
  - providing confidentiality agreements for all users of the trade secrets;
  - controlling access to the information;
  - conducting training for those with access; and
  - continually updating the procedures.
- If an owner has taken reasonable steps to secure its trade secrets, it can assert a cause of action against people or entities that misappropriate these trade secrets.

State law governs protection of trade secrets. While almost all states have enacted a form of the Uniform Trade Secrets Act, New York has not enacted the uniform statute. In New York, a cause of action can be brought for misappropriation of trade secrets based primarily on common law.

Each of these legal methods (patents, copyrights, or trade secrets) for protection of AI developments has different requirements, provides different levels of protection, and endures for a different time period. Because of these limitations, AI developments typically cannot be fully protected and developers of AI software must decide which legal method or combination of methods affords them the greatest protection.

HOW DOES THE BANKRUPTCY CODE TREAT AI SOFTWARE?

The Bankruptcy Code's treatment of AI software is straightforward when the debtor owns the software and does not license it to a third party. If the debtor owns the AI software, then the software is property of the debtor's estate under section 541 of the Bankruptcy Code. If the software is not subject to a valid license, a debtor can sell the software free and clear of all claims by third parties. However, developers of AI software are typically not the end users and, therefore, a significant portion of AI software is licensed to third parties. The cost to incorporate AI software into practical uses, produce the end product, market it, and arrange for distribution and sales can be prohibitive. Therefore, developers of AI software often monetize their new technology by licensing the AI software to a third parties that have the resources and expertise to create, market, distribute and sell the product to end users.

HOW DOES THE BANKRUPTCY CODE TREAT LICENSES OF AI SOFTWARE?

The Bankruptcy Code does not define AI. However, the Bankruptcy Code defines IP to include, patents, copyrights, trade secrets, and other forms of IP (§ 101(35A), Bankruptcy Code). The Bankruptcy Code does not include trademarks and foreign-owned IP within the definition of IP. Because AI software typically is protected by either or both patents and copyrights, bankruptcy courts may treat a license for AI software as if it were a license for the underlying patented or copyrighted code.

Section 365(n) of the Bankruptcy Code affords special protection to non-debtor IP licensees, so that if the debtor rejects an IP license, the non-debtor licensee may either:

- Treat the IP license as terminated and collect rejection damages, which are typically cents on the dollar.
- Retain its rights under the license for the duration of the license term plus any extensions that may be exercised by the licensee.

If a licensee chooses to retain its rights under the license, the debtor must allow the licensee to use the license in exchange for:

- Any past due and continuing royalty payments due under the license.

- A waiver of any setoff rights of past or future royalties against the damages resulting from the rejection.
- A waiver of any administrative claim it may have resulting from performance under the license.

The non-debtor licensee is also protected from the debtor-licensor's interference with the licensee's rights to exploit the license. However, after rejection, the debtor-licensor cannot be compelled by specific performance to perform obligations under the license. For more information regarding the retention by a licensee of an IP license under section 365(n), see Practice Note, IP Licenses and Bankruptcy: Rights and Obligations When a Non-Debtor Licensee Retains a License (1-504-3602).

Also, a non-debtor's rights under section 365(n) are not curtailed merely because the debtor-licensor has ceased operations. Where a debtor-licensor has stopped operating after filing a bankruptcy case, the non-debtor licensee must ensure that its rights under section 365(n) are protected. A liquidating debtor (or its trustee) typically seeks to reject all of its licenses and other executory contracts at one time, so the non-debtor licensee must be vigilant in ensuring it responds timely and appropriately to a motion to reject its license to preserve its section 365(n) rights.

Although several AI developers have filed bankruptcy cases, bankruptcy courts have not yet explicitly addressed the treatment of AI licenses. While courts are likely to hold that section 365(n) applies to AI software licenses because AI systems typically incorporate patents and copyrights, it remains to be seen how rejection of AI licenses may ultimately affect a debtor's ability to sell AI software and the effect on non-debtor licensees. The challenge for bankruptcy courts lies in how to address the gaps in protection of AI software under patent, copyright laws, and a combination of the two (see How do AI developers receive protection for new developments?). Although these gaps are present regardless of the AI developer's financial condition, the issues become more focused in bankruptcy cases when the enterprise value of the AI developer is not sufficient to repay all creditors.

Patent and copyright laws also have fundamentally different policy goals than those of bankruptcy law. While patents and copyrights seek to foster the creative process and technological development, bankruptcy seeks to maximize the value of the debtor's estate, which may be accomplished by re-licensing technology to new, higher-paying licensees. Courts must address how to balance these two competing policy goals.

CAN A DEBTOR-LICENSOR SELL ITS AI PATENTS AND COPYRIGHTS FREE AND CLEAR OF EXISTING LICENSES?

Asset sales in bankruptcy can be a tremendously efficient way to maximize the value of the bankruptcy estate while freeing the estate from the cost of operating an underperforming business. A clear advantage to a section 363 sale is the ability to buy and sell assets "free and clear" of the seller's pre-petition liabilities and burdensome contracts and leases. For more information on section 363 sales, see Practice Note, Buying Assets in a Section 363 Bankruptcy Sale: Overview (1-385-0115).

Courts have typically held that if a debtor is the licensor of a patent or non-exclusive copyright, the debtor cannot sell the IP free and clear of the rights retained by patent and non-exclusive copyright licensees after rejection of their licenses (see *In re Sunbeam Prods. V. Chi. Am. Mfg., LLC*, 686 F.3d 372, 377-8 (7th Cir. 2012); *In re Dynamic Tooling Sys., Inc.*, 349 B.R. 847, 856 (Bankr. Kan. 2006)). This means that debtors may sell their own patents and copyrights but the non-debtor licensees are entitled to continue exploiting the licensed IP under the terms of their prepetition licenses. Because AI technology is typically protected using patents and copyrights, or a combination of the two, bankruptcy courts are likely to treat the sale of AI systems that are subject to licenses in the same manner.

CAN A DEBTOR-LICENSEE ASSIGN ITS LICENSES FOR AI SOFTWARE ABSENT CONSENT OF THE LICENSOR?

When the debtor licenses IP from a third-party, the Bankruptcy Code generally prevents assignment of these licenses absent express consent of the licensor. Courts are likely to treat licenses of AI software in the same manner. Therefore, courts may apply section 365(c) of the Bankruptcy Code, which creates an exception to the general rule that anti-assignment clauses are not enforceable in bankruptcy cases where applicable non-bankruptcy law excuses the non-debtor from accepting or performing for an entity other than the debtor (see Practice Note, IP Licenses and Bankruptcy: Applicable Law under Section 365(C) (1-504-3602)).

Courts have consistently held that patent licenses and non-exclusive copyright licenses are like personal service contracts, which are not assignable under state common law because they involve a special relationship, knowledge, or skill. Courts have reasoned that assignment of patent licenses without the owner's consent deprives the patent owner of control over the patent. In that case, patent owners would be unable to prevent competitors from licensing its technology, which undermines the rewards bestowed by patents for the development of new inventions.

Therefore, debtors seeking to assign their rights under a patent or non-exclusive copyright license must obtain consent from the patent or copyright owner. Courts have held that both exclusive and non-exclusive patent licenses cannot be assigned without consent (see *In re Hernandez*, 285 B.R. 435 (Bankr. D. Ariz. 2002)). Courts are likely to apply this treatment to licenses of AI software, particularly where AI software has been patented.

While courts agree that patent and non-exclusive copyright licenses cannot be assigned without consent, courts have differed whether this treatment also applies to exclusive copyright licenses. Most courts reason that because an exclusive copyright license transfers all of the protections of owning a copyright to the licensee, an exclusive copyright license may be assigned in bankruptcy without the consent of the licensor (see *Golden Books Family Entm't*, 269 B.R. 311 (Bankr. D. Del. 2001); *Patient Educ. Media*, 210 B.R. 237, 243 (Bankr. S.D.N.Y. 1997)).

By extension, if AI software is protected solely by an exclusive copyright, AI licenses may be treated similarly. While it is unlikely that a developer's AI software is protected only by an exclusive copyright license, practitioners should be aware that the US Court of Appeals for the Ninth Circuit reached the opposite conclusion, holding that exclusive copyright licenses cannot be transferred without consent of the licensor (see *Gardner v. Nike Inc.*, 279 F.3d 774 (9th Cir. 2002)).

For a detailed analysis of assignability of IP licenses, see Practice Note, IP Licenses: Restrictions on Assignment and Change of Control: Assignability of License (3-517-3249).

CAN A DEBTOR-LICENSEE ASSUME PATENT AND NON-EXCLUSIVE COPYRIGHT LICENSES FOR AI ABSENT CONSENT OF THE LICENSOR?

While courts generally agree that patent licenses and non-exclusive copyright licenses cannot be assigned without consent of the licensor, courts are split regarding whether a debtor-licensee can assume these licenses and perform under them after exiting bankruptcy. Depending on the circuit, courts generally take one of three primary approaches:

- The "hypothetical test," adopted by the majority of circuit courts, including the Third, Fourth, Ninth, and Eleventh Circuits.
- The "actual test," favored by courts in the First and Fifth Circuits.
- A third approach adopted by the US Bankruptcy Court for the Southern District of New York in *In re Footstar*, 323 B.R. 566, 569 (Bankr. S.D.N.Y. 2005)

Courts in the majority of circuits have adopted the "hypothetical test" holding that a debtor cannot assume an IP license as a debtor-in-possession if it cannot assign the license to a hypothetical third party under applicable law, even if the debtor does not intend to assign its license rights to a third party (see *In re Sunterra Corp.*, 361 F.3d 257 (4th Cir. 2004); *In re Catapult Entm't, Inc.*, 165 F.3d 747 (9th Cir. 1999); *In re James Cable Partners, L.P.,* 27 F.3d 534 (11th Cir. 1994); *In re W. Elec. Inc.*, 852 F.2d 79 (3d Cir. 1988)).

These courts reason that the language of section 365(c) prevents assumption "or" assignment under certain conditions. Therefore, these courts hold that if a license cannot be assigned, the debtor also cannot assume it. A debtor licensing valuable IP rights that files a bankruptcy case in the Third, Fourth, Ninth, or Eleventh Circuits therefore faces an insurmountable obstacle to reorganizing without the IP licensor's consent. This result can have a significant impact on debtor-licensees of AI software.

The First and Fifth Circuits favor an alternative "actual test" in which the assignment limitations under applicable non-bankruptcy law are not triggered unless the debtor actually intends to assign the contract to a third party (see *In re Mirant Corp.*, 440 F.3d 238 (5th Cir. 2006); *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489, 493 (1st Cir. 1997)).

Under this test, the courts treat the debtor-in-possession as the same entity as the prepetition debtor for purposes of assuming a license, which cannot be assigned to a third party without the non-debtor licensor's consent. Courts in these Circuits are likely to apply this analysis to the assumption of AI licenses.

In the Southern District of New York, the bankruptcy court applied a different approach in *Footstar*, holding that the term "trustee" as used in section 365(c)(1) should not be read to mean "debtor-in-possession." Based on this reading, the court held that section 365(c)(1) is limited to situations where the trustee, rather than the debtor-in-possession, seeks to assume a contract.

In a bankruptcy case in a jurisdiction where the circuit court has not yet adopted any of these approaches, the parties face substantial litigation risk. In these jurisdictions, as a matter of strategy:

- A debtor-licensee of AI software is likely to press the court to adopt the actual test or the Footstar approach to permit assumption of an otherwise non-assignable contract.
- A non-debtor licensor of AI software is likely to seek application of the hypothetical test so that the debtor-licensee cannot assume the AI license agreement.

LOOKING AHEAD, WHAT CAN DEVELOPERS AND LICENSEES OF AI DO TO PROTECT THEIR RIGHTS AND INTERESTS IN ANTICIPATION OF A BANKRUPTCY FILING?

While bankruptcy courts have not yet formally opined on cases where the ownership, licensing, or value of AI software is disputed, both AI software developers and licensees can take several steps to protect their interests and rights:

Licensors may take certain measures to protect themselves, including:

- Agreeing on a date certain when the license terminates, rather than an automatic renewal. This may protect a licensor when a licensee file for bankruptcy because the licensor is prevented from terminating the license under the automatic stay.
- Incorporating a provision in the license agreement that grants the licensor the right to terminate the license within a specific number of days after the licensee fails to pay the license fee. The licensee is often late on making payments when it faces financial difficulty. However, many software licenses do not specify the conditions by which the licensor can terminate the AI software license. If the software license is terminated for a valid cause prior to the filing of a debtor-licensees bankruptcy case, the bankruptcy case does not revive the terminated license.
- Ensuring that the license agreement specifies that the new code created by AI software is owned by the licensor.
- Vigilantly monitoring the licensee's financial condition and ability to timely pay royalty payments as this may allow the licensor to protect itself in the event of a default. While a licensor may terminate the license before the bankruptcy of the licensee if there is sufficient cause, a licensor cannot terminate a license after the licensee files a bankruptcy, even if the licensee is in default under the license.

Licensees may take certain measures to protect themselves, including:

- Ensuring that the data collected by use of the AI software remains the licensee's property, subject to appropriate confidentiality terms.
- Requesting a security interest in the license. This may support the argument in a debtor-licensor's bankruptcy case that the license cannot be rejected as an executory contract under section 365 of the Bankruptcy Code. However, this strategy requires the licensor to incur some form of indebtedness to the licensee, which it may be resistant to do.

Both the licensor and the licensee can also agree on language in the license agreement regarding the treatment of the licensee's rights if there is a breach by the licensor. While treatment of AI software cannot be completely controlled by private agreements, the more specific the license is regarding post-breach treatment, the more likely a court may consider enforcing the provisions after rejection of the contract. Both the AI software licensor and the licensee benefit by knowing the possible outcome if the other party files a bankruptcy case.