Can a Bankrupt Company Assign Its Patent License to the Highest Bidder, Even When the License Itself Forbids Assignment? Why *Everex Systems, Inc. v. Cadtrak Corp.* Gives an Unconvincing Answer

by Matt Siegel

A patent licensee that declares bankruptcy will often want to assign its rights under the license to another party in exchange for much-needed cash. The Bankruptcy Code generally allows debtors to assign executory contracts, including patent licenses, in this way. Indeed, the Code permits debtors to assign a contract even if the contract itself contains a "no-assign" clause, i.e., a clause expressly forbidding assignment. But there is an exception: The Code will defer to certain kinds of otherwise applicable non-bankruptcy law that would normally prevent the contract from being assigned. In particular, the Code will not allow assignment by a debtor-licensee if, outside of the bankruptcy context, the applicable non-bankruptcy law would bar assignment regardless of whether the contract contained a no-assign clause or not.

Two bodies of non-bankruptcy law speak to the assignment of patent licenses. State contract law generally permits assignment unless the license says otherwise, while a longstanding rule of federal common law generally *bars* assignment unless the license says otherwise. Careful reflection on these two rules reveals that the federal common-law rule is the type of non-bankruptcy rule the Code will defer to, while the state contract law rule is not. Thus, if state contract law governs questions of patent license assignability outside of bankruptcy, then inside bankruptcy the Code will permit assignment by a bankrupt licensee. On the other hand, if federal common law governs those questions outside of bankruptcy, then inside bankruptcy the Code will defer to the federal rule, and will prevent the bankrupt licensee from assigning. Thus, the question of whether a bankrupt licensee can assign a patent license containing a no-assign clause reduces to an *Erie* question about which body of law applies to patent license assignability issues outside of bankruptcy.

Under the *Erie* doctrine, whether state contract law or federal common law applies to patent license assignability questions outside of bankruptcy depends on one thing only: whether the use of state contract law to decide such questions would pose a "significant conflict" with some federal policy. *Everex Systems, Inc. v. Cadtrak Corp.*, the leading case on this topic, concluded that using state law would significantly reduce the value of the federal patent monopoly, thereby significantly conflicting with federal patent policy, and that federal common law must therefore apply. Other authors have criticized *Everex*, most forcefully by arguing that Congress has tacitly indicated that there is no federal policy of protecting the value of the patent monopoly against ordinary variations in state contract law. But such arguments ultimately rest on the authors' particular, and easily assailable, interpretation of Congressional silence on the subject of patent licenses.

The present article offers a more fundamental critique of *Everex*: Even if we assume, as the *Everex* court did, that protecting the value of the patent monopoly against variations in state contract law is a genuine goal of federal policy, *Everex* still contains a serious flaw. *Everex* concluded that applying state contract law to patent license assignability questions (not in the bankruptcy context, but generally) would significantly undermine the patent monopoly overall, because it would mean that, within any bankruptcy, the no-assign clause in a patent license would always be ignored, destroying much of the patent's value.

But the court failed to account for the fact that this insult to the patent's value occurs only when the licensee *happens to be bankrupt*. Outside of the bankruptcy context, the Bankruptcy Code does not apply, and no-assign clauses in patent licenses are routinely enforced, whether one is using state contract law or federal common law. Thus, from the perspective of the would-be innovator—the scientist or R&D director whose behavior the federal patent policy seeks to shape—the *ex-ante* expected value of the patent may not be significantly reduced by the use of state law as opposed to federal common law. In particular, this *ex-ante* expected value will not be substantially diminished *if the probability is low that the eventual licensee of the patented invention will end up going bankrupt*. *Everex* ignored this empirical element of the *Erie* analysis—an element that can also be applied in many other, non-patent, settings. In short, the *Everex* court fell into the trap of imagining that the injury to the patent monopoly in the general case would be of the same magnitude as the injury to the patent monopoly in the case that happened to be before the court that day. It would not, for the simple reason that most patent licensees do not go bankrupt.

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I. Introduction.[1]

When a technology-intensive company declares bankruptcy, some of the bankruptcy estate's most valuable resources are likely to be the company'spatent licenses.[2] A patent license allows the company to use a proprietary technology at some previously agreed royalty rate, and if the royalty payments under the license are less than the expected profit one could earn by using the patented technology, the license can be a source of significant value for the licensee. A bankrupt licensee will often want to capitalize on its patent licenses by assigning its rights under them to the highest bidder in exchange for payment. This can enable the bankrupt company to better reimburse its creditors in a liquidation scenario, and can also facilitate the company's reorganization under Chapter 11 of the Bankruptcy Code ("the Code").

Because so many technology-intensive companies declared bankruptcy in the wake of the stock-market dive of 2000, bankruptcy courts in the past several years have seen a significant number of cases in which the special legal problems associated with patent licenses loom large.[3] The National Conference of Bankruptcy Judges, at its October 2000 annual meeting, was already devoting a major portion of its program to the question of whether Chapter 11 is "a meaningful tool for the rehabilitation and restructuring of high-technology companies."[4] The treatment of

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[1] I would like to thank Prof. Barry Adler of New York University School of Law and John DiPaolo of the Temple University Partnership Schools, who gave me advice on various drafts of this article. Crystal Glynn of NYU Law School's Office of Career Services has also earned my thanks, as have Professors Rochelle Dreyfuss and Harry First of NYU, who provided useful criticism on an early draft, and Susan Hansen, who helped me simplify and clarify the setup of the legal problem.

[2] *See, e.g.*, Donald F. Parsons, Jr. & John D. Pirnot, *The Intersection of Patent Law and Bankruptcy: What Every Practitioner Should Know*, DEL. LAW., Winter 2000, at 30 (2000) ("a patent license may be among a debtor's most valuable assets").

[3] *See* David R. Kuney, *Intellectual Property Law in Bankruptcy Court: The Search for a More Coherent Standard in Dealing with a Debtor's Right to Assume and Assign Technology Licenses*, 9 AM. BANKR. INST. L. REV. 593 (2001) (noting that "the financial debris of the excess exuberance has now fallen into the bankruptcy courts . . . .").

[4] *See id.* (substantial portion of meeting program devoted to this topic).

patent licenses in bankruptcy has also attracted a fair amount of scholarly attention,[5] both because of its practical importance in a technology-intensive economy and because there is still serious doubt among experts about exactly when a bankrupt licensee should be allowed to assign its rights to third parties.

One Code provision suggests that a bankrupt licensee can generally assign its rights under a patent license to a third party. Indeed, this provision of the Code suggests that the licensee can assign these rights *even if the license itself contains a clause explicitly prohibiting assignment* (which for the purposes of this discussion we will call a "no-assign clause"). But

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[5] *See* Brett W. King, *Assuming and Assigning Executory Contracts: A History of Indeterminate "Applicable Law,"* 70 AM. BANKR. L.J. 95 (1996) (discussing a drafting paradox in the Code, relevant to patent-license assignability in bankruptcy but not the focus of this paper, caused by the fact that Section 365(f) explicitly permits a trustee or debtor-in-possession to assign even if it would override "applicable law," while Section 365(c)(1)(A) defers to certain kinds of "applicable law"); Kuney, *supra* note 3, at 593 (reviewing in depth the issue of patent-license assignability, concluding that the post-Erie trend in which federal courts apply federal common law to the issue has been implemented somewhat blindly and will likely be reconsidered by courts, and concluding that the sensible approach is to do away with the blanket rule and establish a new rule under which patent licenses are presumed assignable only when assigning them would have no material adverse impact on licensor); Aleta A. Mills, Note & Comment, *The Impact of Bankruptcy on Patent and Copyright Licenses*, 17 BANKR. DEV. J. 575 (2001) (recommending special legislation allowing a debtor-in-possession to assume a non-exclusive patent or copyright license, but providing that it cannot assign such a license unless the license itself so specifies); Parsons & Pirnot, *supra* note 2 (discussing patent-license assignment in bankruptcy as part of a practitioner's survey of issues at intersection of patent and bankruptcy law); Marie T. Reilly, *The Federal Interest in the Transfer of Patent License Rights in Bankruptcy*, 10 J. BANKR. L. & PRAC. 3 (2000) (applying economic efficiency analysis to the policy underlying the "applicable law" exception in Section 365(c)(1)(A) of the Code, which covers assignability of patent licenses in bankruptcy); Carole A. Quinn & R. Scott Weide, *Violation of the Erie Doctrine: Application of a Rule of Federal Common Law to Issues of Patent License Transferability*, 32 CREIGHTON L. REV. 1121 (1999) (reviewing the issue of patent-license assignability in bankruptcy, and concluding that applying federal common law to issues of patent-license assignability in bankruptcy violates the Erie doctrine, because no specific federal policy or interest dictates that the patentee should be shielded from unwise transfer of rights and because applying state law to the issue does not necessarily give a result at odds with the federal rule); Daniel A. Wilson, Note, *Patent License Assignment: Preemption, Gap Filling, and Default Rules*, 77 B.U. L. REV. 895 (1997) (arguing for a default rule that patent licenses are freely assignable unless the license itself says otherwise, in discussion about both patent-license assignability in bankruptcy and patent-license "assignment" by corporate merger of licensee into second company). *See also*, Jessica L. Braeger, Note, *Antiassignment Clauses, Mergers, and the Myth About Federal Preemption of Application of State Contract Law to Patent License Agreements*, 50 DRAKE L. REV. 639, 652-53 (2002) (in discussion about patent license "assignment" through corporate merger of licensee into second company—unrelated to bankruptcy—asserting that Erie doctrine requires that state merger law trump federal common law presumption against patent-license assignment).

another provision of the Code—an exception to the first—says that the Code will defer to certain kinds ofnon -bankruptcy law that would ordinarily bar assignment of the license in question outside of the bankruptcy context. If the Code does defer to such non-bankruptcy law, the bankrupt licensee will not be allowed to assign. In short, the Code does not provide a simple answer.

It is important to note that the Code does not defer to *all* non-bankruptcy law that would ordinarily bar assignment, but only to certain kinds of non-bankruptcy law that would do so. In particular, the Code will not allow a bankrupt licensee to assign if the applicable non-bankruptcy law would normally bar assignment *whether or not the license contained a no-assign clause*. This last phrase defines the subset of non-bankruptcy law thatthe Code will defer to, as shown in by Chart 1 below.

SITUATION OUTSIDE BANKRUPTCY	→ [*Implies*]	**SITUATION INSIDE BANKRUPTCY**
Applicable non-bankruptcy law bars assignment only when the license itself prohibits assignment.	→	**Code will <u>allow</u> <u>assignment</u> by the debtor, overriding the non-bankruptcy rule**
Applicable non-bankruptcy law bars assignment <u>regardless</u> of whether the license prohibits assignment.	→	**Code will <u>bar</u> <u>assignment</u> by the debtor, deferring to the non-bankruptcy rule.**

<u>Chart 1. How the Code Treats Assignment of a Patent License that Contains a Clear No-Assign Clause</u>

Thus, the problem of whether a bankrupt licensee (sometimes referred to here as "the debtor") can assign a patent license containing a no-assign clause reduces to a choice of-law problem—a question of which body of law applies to patent license assignability outside of bankruptcy. If the applicable body of non-bankruptcy law is of the sort the Code will defer to (the sort described in the shaded box in Chart 1), then the Code will not allow the bankrupt licensee to assign. But if the applicable non-bankruptcy law is not of that sort, the Code's general preference for assignability will prevail, and the debtor will be allowed to assign.

As we will see, when one considers which body of non-bankruptcy law should govern issues of patent license assignability outside of bankruptcy, one finds that there areonly two candidates: state contract law, and a rule of federal common law developed in the 1850s and meant to apply specifically to patent licenses. In general, state contract law permits the assignment of a contract—including a patent license—unless the contract explicitly states otherwise. (This, at least, is a fair simplification to use for the purposes of this discussion.[6]) The federal common-law rule shifts the presumption in favor of assignability. That is, federal common law *prohibits* the assignment of a patent license unless the license explicitly states otherwise. Thus, the two bodies of law disagree only in how they treat a license that is silent on the question of assignability. But this turns out to be a very important difference, because it means the Bankruptcy Code will defer to one body of law and not the other. To see this, consider Chart 2, which illustrates the difference between the two bodies of law.

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[6] The content of state law regarding contract assignability is discussed in greater detail at note 26, *infra*. It is certainly the case that, in most states, the vast majority of contracts are presumed assignable unless they say otherwise. Patent licenses present a difficult case. The court in *Everex*—the case whose analysis is the subject of this paper—assumed that California state law (which is fairly typical on such issues) would have permitted assignment of the license in question had it not contained a no-assign clause. Therefore, it makes sense for us, too, to assume that state law favors assignability of patent licenses, for the purposes of assessing the logic of *Everex*. (Otherwise we will be bogged down in a debate with the *Everex* court about a state-law question that has no definitive answer.) The relevant language from the Restatement (Second) of Contracts, and an explanation of why this language does not fully resolve the issue of whether all patent licenses are presumed assignable under state law, can be found at note 26, *infra*.

	License says "licensee may assign"	**License is silent on assignability**	**License says "licensee may not assign"**
State law rule	assignment permitted	assignment permitted	assignment <u>not</u> permitted
Federal common-law rule	assignment permitted	assignment <u>not</u> permitted	assignment <u>not</u> permitted

<u>Chart 2</u>. Federal common law says a patent license <u>may not</u> be assigned unless the license says otherwise, whereas state contract law says a license <u>may</u> be assigned unless the license says otherwise.

Chart 2 illustrates the fact that, as between these two bodies of law, only the federal common-law rule bars assignment *whether the license contains a no-assign clause or not*. (I.e., the federal rule bars assignment in both the middle column and the right-most column of Chart 2.) But this is precisely the precondition that is needed for the Code to bar assignment by a bankrupt licensee. (To see this, look back at Chart 1.) Thus, if state contract law applies to questions of patent license assignability outside of bankruptcy, then inside bankruptcy the Code will override thatlaw, and bankrupt licensees will be allowed to assign, even in the face of a clear no-assign clause. On the other hand, if patent license assignability questions outside of bankruptcy are governed by federal common law, then inside bankruptcy the Code will defer to that non-bankruptcy rule, and bankrupt licensees will not be allowed to assign in the face of a no-assign clause. In short, the fate of the debtor-licensee who is saddled with a no-assign clause depends entirely on which of these two bodies of law applies to patent license assignability questions outside of bankruptcy.

To determine which of these two bodies of law does apply outside of bankruptcy, one must use the sort of analysis found in the line of cases following *Erie Railroad v. Tompkins*.[7] These cases, which are a mainstay of any "federal courts" class in law school, describe the

[7] 304 U.S. 64 (1938).

limited circumstances under which courts may supplant state law with federal common law. Patent license assignability questions, because they are questions of contract interpretation, will generally be governed by state contract law unless they are covered by some specific exception to *Erie*'s broad proscription of federal common law. If an *Erie* exception does apply, federal common law will govern themThis article will argue that there is just one circuit-court case, *Everex Systems, Inc. v. Cadtrak Corp.*,[8] that has ever attempted a serious application of the *Erie* doctrine to the problem of determining which body of law applies to questions of patent license assignability.

As the *Everex* court concluded, the most relevant strand in the *Erie* line of cases would permit the use of federal common law to decide such questions only if using state contract law to decide them would *significantly conflict with some federal policy*. The *Everex* court had little difficulty concluding that using the state law rule would indeed significantlyconflict with a federal policy, namely federal patent policy. "Allowing free assignability—or, more accurately, allowing states to allow free assignability—of nonexclusive patent licenses, would undermine the reward that encourages invention," the court wrote.[9] In other words, if state contract law were allowed to control issues of patent license assignability outside of bankruptcy, then, whenever a licensee went bankrupt, the Code would allow the licensee to assign, even if the license contained a no-assign clause. For reasons explained in Part II below, overriding a no-assign clause in this fashion often renders the license far less valuable to the licensor, and thus seriously diminishes the value of the patent monopoly. That is why, in the view of the *Everex* court, applying state law to questions of patent license assignability outside of bankruptcy would

[8] 89 F.3d 673 (9th Cir. 1996).

[9] *Id.* at 679.

surely "undermine the reward that encourages invention," due to its baneful effects on the patent's value in situations where the licensee is bankrupt.

This conclusion has not been immune to scholarly critique. The most fundamental attack on *Everex*, offered by Carole A. Quinn and R. Scott Weide,[10] asserts that Congress's persistent failure to amend the Patent Act to include so much as a reference to patent licenses, even in the face of numerous court battles over which body of law should govern the assignability of such licenses, should be considered a tacit acknowledgment by Congress that there is no federal policy of protecting the value of the patent monopoly against ordinary variations in state contract law. But as we will see in Part V, this critique relies heavily on its authors' assumptions about the meaning of Congressional silence, and those assumptions can easily be turned on their heads in the absence of factual evidence that is almost certainly unavailable.

This article maintains that arguments such as the one advanced by Quinn & Weide are not necessary to discredit the *Everex* decision, because the *Everex* decision contains a serious logical error even on its own terms—that is, even if one assumes thatthere *is* a federal policy of maximizing the value of the patent monopoly. Here is the core of the argument. *Everex* found that using state contract law to decide questions of patent license assignability would significantly undermine federal patent policy by significantly diminishing the economic value of the patent. If state law were to govern questions of patent license assignability, *Everex* found, then bankrupt licensees could always violate the no-assign clauses in their patent licenses, thereby robbing the patent holders of significant value. But in reaching this conclusion the court overlooked an important fact about the world—namely, that *most licensees do not end up in bankruptcy*. The *Everex* court reasoned that if we were to use state law to decide questions of

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[10] Quinn & Weide, *supra* note 5.

patent license assignability, "every licensee" would suddenly be permitted to disregard the no-assign clause in its patent license, robbing the licensor of his monopoly profits. But in fact, "every licensee" would not be permitted to do this. Only *bankrupt* licensees would. Outside of bankruptcy, the use of state law does not frustrate no-assign clauses in the least. Outside of bankruptcy, both state and federal common law lead to the same result: If a license contains a no-assign clause, it may not be assigned. (To confirm this, look back at the right-most column in Chart 2.) Only in the event of *licensee bankruptcy* does the use of state law undermine the license's no-assign clause. And licensee bankruptcy may, in fact, be quite rare.

Certainly, from the perspective of the licensor whose licensee has already declared bankruptcy, the use of state law to decide questions of patent license assignability significantly reduces the value of the patent. But thatis not the perspective federal patent policy cares about. Federal patent policy, by definition, is concerned only with the perspective of the *would-be innovator*, i.e., the scientist in her laboratory trying to decide how much effort to put into her next research project. From this person's perspective, the use of state law to decide questions of patent license assignability might *not* significantly diminish the expected value of the patent. It all depends on the *ex-ante* expected probability that the innovator's future licensee will go bankrupt. Only if the expected probability of licensee bankruptcy is fairly high will the use of state contract law significantly impair the *ex-ante* expected value of the patent, and thus the incentive to innovate.

If a court wishes to opine on whether the use of state law to decide issues of patent license assignability "significantly" reduces the patent's value from the *ex-ante* perspective, that court must necessarily weigh in on the *ex-ante* probability that a patent licensee will go bankrupt, which is a purely empirical question. The *Everex* court never took a position on the probability of licensee bankruptcy, indeed never even mentioned that it might be relevant. And *Everex*'s scholarly critics have likewise ignored this most glaring shortcoming of the court's opinion. The point of this article is not to argue that the *Everex* court's conclusion was necessarily wrong, but to show that one cannot possibly know whether it was wrong or not, without some notion of the probability of licensee bankruptcy. This observation should be uncontroversial, and yet it has somehow eluded both the *Everex* court and its critics.

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Part II of this article explains why patent licensors often have compelling economic reasons for wanting to insure thattheir licenses are not assigned. As a result, many licenses do contain no-assign clauses. Part III discusses Sections 365(f)(1) and 365(c) of the Bankruptcy Code. Section 365(f)(1) gives a bankrupt licensee the right to assign its license to a third party in most cases, even when the license contains a clear no-assign clause. Section 365(c) creates an exception to that rule in certain circumstances (as shown in the gray box in Chart 1). Based on these two provisions of the Code, Part III will show that if state contract law applies to questions of patent license assignability outside of bankruptcy, then inside bankruptcy the debtor-licensee will be allowed to assign, but if federal common law applies to those questions, the debtor-licensee will not be allowed to assign. Thus, whether or not a bankrupt licensee may assign boils down to an *Erie* analysis.

Part IV describes the two federal circuit cases that have attempted this *Erie* analysis, and concludes that only one of them, *Everex*, supplies an intelligible argument that future courts might be tempted to follow. Part V reviews the two main critiques of *Everex* in the existing literature, and shows that one of them, even if correct, would be confined to the facts of *Everex* and would not undermine its basic legal conclusion, while the other relies on its authors' subjective, and eminently assailable, imputation of meaning to Congressional silence.

Part VI argues for a more robust critique of *Everex*: the fact that the *Everex* court failed to take a position on the probability of licensee bankruptcy. The need for an empirical, probabilistic *Erie* analysis, which the *Everex* court overlooked, is not an entirely new idea. In fact, the Supreme Court made this same point, in a totally different context, in *Robertson v. Wegmann*.[11] This case is also discussed in Part VI, and its similarities to *Everex* are noted. Part VII anticipates, and rejects, a few reasons why one might doubt this article's main conclusion. (Part VII is somewhat technical and can be skipped, or skimmed, on a first reading of this article.) Finally, Part VIII sketches out the sort of analysis the *Everex* court should have used, and that future courts might employ when confronted with similar questions. Part VIII also observes that the basic argument of this article can be applied to other *Erie* problems having nothing to do with patents or patent licenses. In particular, it can be used in any case where the federal government has set up a regulatory or statutory scheme designed to give people incentives to behave in a certain fashion, and where the use of state law can dampen the federally created incentives, but would dampen them incentives only in a particular set of circumstances. Critically, for this article's logic to apply, the person who is the target of the federal incentive must, at the moment of his decision, be unable to predict whether he will fall into one of the incentive-dampening circumstances or not.

[11] 436 U.S. 584 (1978).

II. The question of patent license assignability in bankruptcy is one of considerable economic importance, and its practical effects go beyond the bankruptcy context.

Before plunging into the legal analysis, we should first try to understand the practical context in which it arises. The licensing of patents is a common occurrence. Some businesses are good at coming up with new technologies, while others excel at applying those technologies in the marketplace. Rather than forcing every patentee to sell the fruits of its own research, the law allows innovators to license their proprietary technologies to the companies that will best employ them.

Clearly, a patent license can be made explicitly assignable by its terms, can explicitly forbid assignment, or can be silent on the issue of assignability. This latter possibility—contractual silence—raises interesting questions, but it will not be our primary focus here, because the licenses that cover the most valuable technologies are usually drafted by expert patent lawyers who are unlikely to overlook the important issueof assignability. [12] We are left, then, with those licenses that are explicitly assignable, and those that contain a "no-assign" clause—a clause prohibiting assignment. If a patent license is assignable by its terms, the legal problem at the heart of this article disappears. Licenses that are explicitly assignable outside of bankruptcy remain assignable under the Code, and the thorny questions raised by Section 365 never arise. But in fact, firms that license their patented technologies often prefer that the licenses *not* be assignable, and therefore many valuable patent licenses contain no-assign clauses. This occurs for two reasons.

First, when a license is non-exclusive—i.e., when the licensor retains the right to license its technology to other licensees—the licensor will often want to assure that the technology

[12] Section VII.C briefly considers how the analysis of this paper might be extended to include licenses that are silent on the question of assignability.

cannot be assigned so that it can protect its own ability to charge high royalties to subsequent licensees. If the first licensee could freely assign its rights to others, then anyone else wishing to use the technology could purchase it from either the licensor or the first licensee. By playing the two off against each other, someone interested in the technology would likely be able to negotiate a lower royalty rate than he could havegotten had he been negotiating with the patent holder alone.[13] Second, whether or not a license is exclusive, the licensor will often insist on a no-assign clause to protect its competitive advantage. A patent-holder frequently uses its patented technology to achieve an advantage in its own industry, and it may be willing to license the technology only to firms in other industries, secure in the knowledge that they could not possibly use the technology to compete in the licensor's home market.[14] Without a no-assign clause, the licensee could turn around and assign the license to the licensor's main competitor, destroying the licensor's competitive advantage.[15] For both of the above reasons, a significant number of patent licenses contain no-assign clauses, and those are the licenses we will be most concerned with in thisarticle .[16]

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[13] *See, e.g.*, Everex Systems, Inc. v. Cadtrak Corp., 89 F.3d 673, 679 (9th Cir. 1996) (observing that if one allows a non-exclusive patent license to be assignable, then "a party seeking to use the patented invention could either seek a license from the patent holder or seek an assignment of an existing patent license from a licensee. In essence, every licensee would become a potential competitor with the licensor-patent holder in the market for licenses under the patent[].").

[14] For instance, if engineers a DaimlerChrysler developed a way of improving the durability of headlights, it might be willing to license the technology to a maker of bathroom lighting fixtures but not willing to license it to General Motors.

[15] This is essentially what occurred in Unarco Industries, Inc. v. Kelley Co., 465 F.2d 1303 (1972). *See also* Mills, *supra* note 5, at 580 ("When the debtor is a licensee of a nonexclusive patent or copyright license, the licensor's central concern is that the license may be transferred to a competitor or some other entity that the licensor would not have contracted with.").

[16] Even if a license is nominally "non-assignable," if its value to some third-party firm is sufficiently high, the licensee can try to "assign" the license to that firm, by engaging in a corporate takeover: The third-party firm can simply merge with, or purchase, the licensee. This is what occurred in the case of PPG Industries v. Guardian Industries, 597 F.2d 1090 (6th Cir. 1979). Of course, this sort of "assignment by merger" will happen only in extreme cases. *See* Braeger, *supra* note 5, for a discussion of corporate takeovers of this type.

Having described the economic context in which issues of patent license assignability arise, we should also note that the treatment of such issues by bankruptcy courts has practical consequences far beyond the bankruptcy context. Suppose, for example, that courts interpret the Code to permit assignment by bankrupt licensees. In that case, whenever a would-be licensor and licensee are negotiating the terms of a license, the licensor will demand higher royalty payments to compensate it for the risk that the licensee might someday declare bankruptcy and thereby gain the right to assign the license. It is as if the licensor is forced to sell the licensee a kind of "bankruptcy insurance," by awarding the licensee the valuable right to assign only in those instances when the licensee has declared bankruptcy. At the time the license is signed, if the two parties think the chance of an eventual bankruptcy is high, then the licensor will charge a high premium for this bankruptcy insurance (i.e., high royalty payments), and a license that would otherwise have been signed might be rendered jointly disadvantageous to the two parties, such that no deal can be struck at any price. On the other hand, if licensee bankruptcy appears very unlikely (or if it appears that the harm to the licensor from the licensee's assignment of its patent rights would be slight), then the licensee will pay only a small premium for its "bankruptcy insurance," and the overall effect on economic efficiency will be negligible.[17] The point is this: The expected probability of licensee bankruptcy will affect the royalty rates paid by all licensees, even the ones who never end up in bankruptcy, just as a person's expected

[17] One might think that, like any other kind of insurance against a risk where the risky behavior itself can yield some benefit to the insured party, this indirect form of bankruptcy insurance could create some "moral hazard." Specifically, it might give licensees an incentive to take more business risks prior to bankruptcy. The licensee's shareholders would enjoy the increased expected returns that resulted from the business risks, and would be partly insured when those risks resulted in large losses and the company was forced into bankruptcy. But in fact, this sort of moral hazard would be negligible, because the benefits of the bankruptcy insurance would be enjoyed mainly by the licensee's creditors, not by the shareholders who had controlled the firm's investment decisions prior to bankruptcy.

I thank John DiPaolo, of the Temple University Partnership Schools, for pointing out that the insurance metaphor was better than the lottery metaphor used in earlier drafts.

probability of contracting emphysema will affect his health insurance premiums even if he never ends up getting the disease. So, the treatment of patent licenses in bankruptcy is not just a "bankruptcy issue." Its economic effects spill over into the non-bankruptcy world.

III. Whether a bankrupt licensee may assign despite a no-assign clause depends entirely on whether questions of patent license assignability are governed by state contract law or federal common law, outside of the bankruptcy context.

The statutory analysis of whether patent licenses are assignable by a bankrupt licensee begins with Sections 365(a) and 365(f)(1) of the Code. These sections provide that, in a bankruptcy, the debtor may assign all of its executory contracts, including patent licenses, even when those contracts contain clear no-assign clauses. This is accomplished in two parts. First, Section 365(a) says that the trustee or debtor-in-possession "may assume or reject any executory contract . . . of the debtor."[18] (In this article, for the sake of simplicity, I will speak of the "debtor" being the one who assumes or assigns a contract, even though it is technically the trustee or debtor-in-possession that does this.) When a contract is assumed under Section 365(a), the debtor and any other parties to the contract continue to be bound by it just as if no bankruptcy had occurred.[19] Another provision of the Code, Section 365(f)(1), says that

> [e]xcept as provided in . . . [Section 365(c)], notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract . . . , the trustee [or debtor-in-possession] may assign [any contract it has assumed under Section 365(a)] . . . ."[20]

Those unfamiliar with the Code may find this surprising. A bankrupt company not only has the right to continue its contractual relationship on the terms it enjoyed before declaring bankruptcy.

[18] 11 U.S.C. § 365(a).

[19] The debtor may even assume a contract it has breached, so long as it promptly cures any defaults and gives "adequate assurance" that it will perform on the contract in the future. *See* 11 U.S.C. § 365(b)(1).

[20] 11 U.S.C. § 365(f)(1). *See also* 11 U.S.C. § 365(f)(2) (trustee may assign executory contract only if he assumes it in accordance with § 365).

It may also assign its contract rights and obligations to the highest bidder, even if the contract itself explicitly prohibits assignment. This heavy-handed rule has been explained as a way of allowing debtors to "monetize" their valuable contract rights, so that creditors can recover more of what they are owed and debtors have a better chance at a successful reorganization.[21]

As we saw in Part I, the Code contains an important exception to this rule of ignoring no-assign clauses in contracts. Section 365(c) says that if some otherwise applicable body of non-bankruptcy law would bar assignment of a contract outside of bankruptcy—and would bar such assignment *regardless of whether the contract contained a no-assign clause or not*—then the Code will defer to this body of non-bankruptcy law. In other words, in such cases the Code will bar assignment of the contract by the debtor, whether the contract contains a no-assign clause or not, just as the non-bankruptcy law would have done.[22] (See Chart 1 above for an illustration of the type of non-bankruptcy law that the Code will defer to.)

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[21] *See, e.g.*, Reilly, *supra* note 5, at 3 ("Under nonbankruptcy law, whether the licensor can block a proposed transfer of patent license rights depends on the terms of the license. . . . Bankruptcy law, however, specifically invalidates restrictions or prohibitions on transfer in order to maximize the value of the rights for the benefit of the estate."); Theresa J. Pulley Radwan, *Limitations on Assumption and Assignment of Executory Contracts by "Applicable Law,"* 31 N.M. L. REV. 299, 300-01 (2001) (noting that courts, as well as most debtors and creditors, prefer reorganization to liquidation, and that the Code must give the debtor the ability to control the disposition of its pre-bankruptcy contracts to help assure a successful reorganization). Whatever public policy gloss we may wish to give it, the rule wiping out no-assign provisions in contracts when a party goes bankrupt amounts to a statutory transfer of wealth from one contract party to the other, activated only by the latter's bankruptcy. Essentially, every contract that contains a no-assign clause has built into it a "bankruptcy insurance" policy of the sort discussed in Part II.

[22] By its terms, Section 365(f)(1) overrides no-assign clauses only "[e]xcept as provided in . . . [Section 365(c)] . . . ." Section 365(c) reads as follows:

> § 365. Executory contracts and unexpired leases
>
> . . .
>
> (c) The trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if —
>
> (1)(A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to

The idea behind Section 25(c) is subtle, but sensible. If the applicable non-bankruptcy law would bar assignment only when the contract contained a no-assign clause, then it would merely be enforcing the language of the contract. If the Code were to defer to such non-bankruptcy law, bankrupt licensees could always point to *state contract law*, which virtually always enforces no-assign clauses, as an applicable body of non-bankruptcy law barring assignment. Then the Code would be forced to bar assignment in virtually every case, and the exception would have swallowed the rule. This is why the Code cannot defer to non-bankruptcy law that merely enforces contractual no-assign clauses.[23] On the other hand, if the applicable body of non-bankruptcy law would bar assignment *regardless* of whether the contract contained

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> an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and
>
> (B) such party does not consent to such assumption or assignment . . . .

11 U.S.C. § 365(c). Note the repetition of the clause "whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties." The second appearance of this clause, in § 365(c)(1)(A), indicates that the Code will defer only to applicable non-Code law that bars assignment in a contract-blind way—i.e., bars it whether or not the contract contains a no-assign clause.

Section 365 is a confusingly drafted provision, and the discussion of it in the main text above has intentionally ignored certain still-unsettled debates about precisely what it means, because those debates would take us far from the main topic of this paper, and are not essential to the arguments presented here. In particular, there are still doubts about (i) whether the words "assume or assign" in the first line of § 365(c) literally mean that whenever the trustee or debtor-in-possession would be prohibited from assigning an executory contract under this provision he would also be prohibited from assuming that contract; and (ii) the different meanings of the term "applicable law" as it is used in § 365(c)(1)(A) and § 365(f)(1), respectively. *See, e.g.*, King, *supra* note 5; Kuney, *supra* note 3; Mills, *supra* note 5; Pulley Radwan, *supra* note 21; Reilly, *supra* note 5.

[23] *See* Reilly, *supra* note 5, at 22 (noting that the second "whether or not" clause in Section 365(c) excludes from "applicable law" rules of contract interpretation that disallow assignment simply because the parties explicitly chose to disallow assignment).

In fact, the question of whether state contract law should even be a candidate for "applicable law" under § 365(c) presents a difficult problem in statutory interpretation. Two definitions of "applicable law" have arisen concerning this part of the Bankruptcy Code, in opinions of the first and sixth federal circuits, and under both definitions one could argue both that state common law should count, and that it should not count, as "applicable law." This paper does not address this additional difficulty, but simply deals with those cases where, as in *Everex*, state common law is found to constitute "applicable law" for § 365(c) purposes.

a no-assign clause, then whoever wrote this law (Congress, the state legislature, etc.) must have done so for overarching policy reasons, beyond the mere desire to enforce private agreements. This is the sort of non-bankruptcy law the Code will deferto . Thus, the Code defers to "policy-based" non-bankruptcy rules that bar assignment, but not to rules that bar assignment merely to enforce privately negotiated no-assign clauses. (See Chart 1 above.)

Once one understands this aspect of Section 365(c), it becomes clear that the central practical question of thisarticle —whether a no-assign clause will be enforced, or ignored, in bankruptcy—can only be answered by looking to the body of non-bankruptcy law that ordinarily applies to questions of patent license assignability. In fact, there are just two candidates. First there is state contract law, the body of law that governs questions of contract assignability generally and almost all other aspects of patent license construction.[24] Second, as we saw in Part I, there is a very old rule of federal common law, which was designed specifically to supplant state contract law on questions concerning the assignability of patent licenses.[25]

[24] *See* Lear, Inc. v. Adkins, 395 U.S. 653, 661-62 (1969) (construction of a licensing agreement on a technology that was under review by the Patent and Trademark Office when the agreement was signed, and that was later covered by a patent, "solely a matter of state law . . . ."); Luckett v. Delpark, Inc., 270 U.S. 496 (1926) (noting general rule that suit by patentee for any remedy in respect of contract permitting use of patent is not a suit under the U.S. patent laws); Everex Systems, Inc. v. Cadtrak Corp, 89 F.3d 673, 677 (9th Cir. 1996) ("The construction of a patent license is generally a matter of state contract law . . . except where state law 'would be inconsistent with the aims of federal patent policy'") (quoting *Lear*, 395 U.S. at 673); McCoy v. Mitsuboshi Cutlery, Inc., 67 F.3d 917 (Fed. Cir. 1995) ("Whether express or implied, a license is a contract 'governed by ordinary principles of state contract law.'") (quoting Power Lift, Inc. v. Weatherford Nipple-Up Sys., Inc., 871 F.2d 1082, 1085 (Fed. Cir. 1989)); Power Lift, Inc. v. Weatherford Nipple-Up Systems, Inc., 871 F.2d 1082, 1085 (Fed. Cir. 1989) ("A license agreement is a contract governed by ordinary principles of state contract law"); Reilly, *supra* note 5, at 13 ("Since Erie v. Tompkins, courts have treated construction of patent licenses as matter of state contract law, except where state law would be inconsistent with the aims of federal patent policy.").

[25] *See* Everex Systems, Inc. v. Cadtrak Corp., 89 F.3d 673, 679 (9th Cir. 1996) (describing the recent history of the federal rule); Troy Iron and Nail Factory v. Corning, 55 U.S. 193, 216 (1852) (setting forth the rule 151 years ago); Bowers v. Lake Superior Lake Superior Contracting & Dredging Co., 149 F. 983, 986 (1906) ("A license to use a patented invention that does not contain words importing assignability is a grant of a mere personal right to the licensee which does not pass to his heirs or representatives and which cannot be transferred to another without the expressed consent of the licensor."); Reilly, *supra* note 5 at 4

For the moment, let us not worry about which of these two bodies of law actually applies to questions of patent license assignability. The answer is unclear. Instead, let us do a thought experiment, and consider both possibilities. Here is a second copy of Chart 2, as a reminder of the content of state law and federal common law concerning patent license assignability:

	License says "licensee may assign"	**License is silent on assignability**	**License says "licensee may not assign"**
State law rule	assignment permitted	assignment permitted	assignment <u>not</u> permitted
Federal common-law rule	assignment permitted	assignment <u>not</u> permitted	assignment <u>not</u> permitted

<u>Chart 2 (second copy)</u>. Federal common law says a patent license <u>may not</u> be assigned unless the license says otherwise, whereas state contract law says a license <u>may</u> be assigned unless the license says otherwise.

First, imagine a world in which questions of patent license assignability are governed by state contract law. In such a world, what will happen when a bankrupt licensee asks the bankruptcy court for permission to assign its license, notwithstanding a no-assign clause? The first thing the judge will do is look to the Code, where she will find Section 365(f)(1), setting forth the general rule that the debtor may assign the license, regardless of the no-assign clause. But the judge will also have to consider Section 365(c), which carves out an exception to the pro-assignability rule of Section 365(f)(1). As we have seen, this exception applies only where applicable non-bankruptcy law would bar assignment regardless of whether the license contains a no-assign clause or not. Here, by assumption, "applicable law" is state contract law, and in most states, contract law principles would bar assignment if the license contained a no-assign

("Courts have developed a federal common law default rule that governs the transferability of patent license rights").

clause but would permit assignment if the license did not, just as shown in Chart 2 above. In other words, state law construes contractual silence in favor of assignability.[26] Thus, it cannot be said that the applicable non-bankruptcy law bars assignment *regardless* of whether the license contains a no-assign clause, because, in fact, state law gives different results *depending on* whether the license contains a no-assign clause or not. I.e., in Chart 2, state law bars assignment in the right-most column but permits assignment in the middle column. Therefore, the condition

[26] The *Everex* court presumed that state contract law would allow assignment of a patent license that does not contain a no-assign clause. In fact, as David Kuney has suggested, *see* notes 50-53, *infra*, a better analysis of state law might have led to the conclusion that the license at issue in *Everex* should have been presumed non-assignable. It is difficult to say how state courts would generally treat the issue of patent license assignability under state law, largely because patent license assignability has typically been controlled by federal common law—partly in response to opinions like *Everex*, which this paper argues may have been wrongly decided. In any case, we know that at least one state supreme court, that of California, did reach the issue under state law, and did conclude that the license in question should be presumed assignable. Farmland Irrigation Co. v. Dopplmaier, 48 Cal. 2d 208, 223-24 (Cal. 1957). For the purposes of this paper, we assume only that the *Dopplmaier* decision was not aberrant. I.e., we assume that there will be some significant number of patent licenses that typical state law doctrine would presume to be assignable absent any contractual language to the contrary. As we will see, the *Everex* decision would apply to those licenses—whether or not the particular license at issue in the *Everex* case was properly considered one of them.

The Restatement (Second) of Contracts Section 317(2) provides that contractual rights (such as the right to use a patented technology) can generally be assigned where such assignment is not precluded by the contract, except in situations where transferring the rights from assignor to assignee "would materially change the duty of the obligor, or materially increase the burden or risk imposed on him by his contract . . . or materially reduce its value to him . . . ." As Marie T. Reilly points out, this language begs the question of what happens under state law when the assignment of a license would result in the very same stream of royalties to the licensor, but where the assignee might, for example, compete with the licensor in the market for patent licenses, thus depriving the licensor of some of profit she would otherwise have enjoyed by selling additional licenses on more favorable terms. Does the loss of bargaining power on a completely separate license with a third party "materially reduce the value" of the first license to the licensor? *See* Reilly, *supra* note 5, at 8 ("In particular, [the Restatement] does not directly address whether an objecting party is entitled to enjoin transfer in order to capture an opportunity to profit," as opposed to an outright loss.)

The *Dopplmaier* court found that the relevant patent license should be presumed assignable under state law, but cited the somewhat different standard of the first Restatement: whether the assignment "would materially impair the nonassigning party's chance of obtaining the performance he expected." Perhaps the change of language between the first and second Restatements reflects some shift in the law of most states, and perhaps the *Dopplmaier* court would interpreted California state law differently had it heard the case in 1997 rather than 1957. In any case, for the purposes of this paper, we assume that at least some state contract doctrines, properly interpreted, give the same result as the *Dopplmaier* and *Everex* courts reached under California state law. We will not be able to settle the debate over whether those courts both misread California law.

of Section 365(c) is not met. Section 365(f)(1) controls, and the Code will permit the debtor to assign.[27]

As the second step in our thought experiment, imagine a world in which questions of patent-license assignability are governed by federal common law, as shown in the bottom row of Chart 2. A line of federal court opinions dating back to 1852 established this judge-made rule, which applies exclusively to patent licenses. The rule states that unlike most other contracts, patent licenses should be presumed to be *non-assignable*, absent some explicit contractual language to the contrary.[28] Thus, if a bankruptcy court is faced with a patent license that contains a no-assign clause, it will be clear to the court that outside of bankruptcy the federal rule would have barred assignment of that license with or without the no-assign clause. In other words, one could havescratched out the no-assign clause and it wouldn't have made any difference, since the federal rule would bar assignment in both the right-most and center columns of Chart 2. Therefore, the condition of Section 365(c) it met. The Code will defer to the federal rule that applies outside of bankruptcy, and the bankruptcy court will not allow the bankrupt licensee to assign.[29]

Our thought experiment is now complete, and the conclusion is clear. If state common law applies to questions of patentlicense assignability outside of bankruptcy, then a bankrupt

[27] *See* Reilly, *supra* note 5, at 18-22, for a discussion of the fact that whether the Code will defer to a certain non-bankruptcy bar on assignability depends entirely on what that non-bankruptcy rule would do if the contract were (hypothetically) silent on the issue of assignability. (The "applicable law" that Section 365(c) will defer to, says Reilly, appears to be limited "to only those rules of contract interpretation that render particular rights non-transferable if (hypothetically) the express agreement of the parties was silent as to transferability." Id. at 21-22.)

[28] *See* Troy Iron and Nail Factory v. Corning, 55 U.S. 193, 216 (1852), and, generally, note 25, *supra*.

[29] Here, again, we are glossing over a rather complex legal debate for the sake of simplicity. In reality, whether the federal common-law rule qualifies as "applicable law" under § 365(c) depends on how one reads that phrase, and a complete analysis would have to consider separately the various possible interpretations, especially the two reached by the first and sixth federal circuits.

licensee may assign its license, notwithstanding a no-assign clause. But if federal common law governs those questions, a bankrupt licensee may not assign, whether the contract contains a no-assign clause or not. In other words, whether a bankrupt licensee can assign its patent license boils down to a choice-of-law question: Does state contract law govern questions of patent license assignability outside of bankruptcy, or does federal common law govern those questions?

* * * * * * * * *

Before turning to this choice-of-law issue, we should make a brief technical qualification to all that follows. Section 365 of the Bankruptcy Code never mentions patent licenses by name. Instead, the section speaks of "[e]xecutory contracts and unexpired leases" held by the debtor.[30] But the term "executory contract," as used in the Code, has routinely been construed to include non-exclusive patent licenses.[31] There is considerable doubt about whether an *exclusive* license

[30] 11 U.S.C. § 365, title.

[31] In bankruptcy parlance, an "executory contract" is any contract the debtor entered into prior to filing for bankruptcy in which some substantial performance was owed by both parties at the time of the filing. *See, e.g.*, Griffel v. Murphy (In re Wegner), 839 F.2d 533, 536 (9th Cir. 1988) (holding that "the meaning of ['executory contract'] in this context is 'a contract . . . on which performance is due to some extent on both sides' and in which 'the obligations of both parties are so far unperformed that the failure of either party to complete performance would constitute a material breach and thus excuse the performance of the other.'") (citations omitted); Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973) (defining executory contracts as ones "under which the obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other."). The legislative history behind the current § 365 refers approvingly to this definition of an "executory contract," often called the "Countryman definition." *See* S. Rep. 95-989, 1978, p. 58, H.R. Rep. 95-595, 1978, p. 307 (observing that the term executory contract "generally includes contracts on which performance remains due to some extent on both sides."); 3 COLLIER ON BANKRUPTCY, ¶ 365.02[1] (Matthew Bender & Co., Inc., ed., 15th ed. revised 2002).

Bankruptcy courts have interpreted this definition very broadly, such that it covers most patent licenses, and almost certainly covers all non-exclusive licenses. For instance, the licensor's duty to take legal action against those who infringe the patent (a provision commonly found in patent licenses), Kuney, *supra* note 3, at 598; *cf.* Kalman v. Berlyn Corp., 914 F.2d 1473, 1481 (Fed. Cir. 1990) (stating would be regarded as an executory contract for the purposes of Section 365. Particularly if the licensor itself had promised to stop using the technology in question, a bankruptcy court might find that an exclusive license more closely resembles an outright transfer of the patent[32] than an executory contract. In such a case, the patent would be treated as an asset of the debtor, not a bundle of contract rights, and Section 365 would not apply. Accordingly, the present discussion can be applied reliably only to non-exclusive patent licenses.

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that "it is well settled that a non-exclusive licensee of a patent has no standing to sue for infringement."), and even the licensor's bare obligation not to sue the licensee for infringement, *see* Everex Systems, Inc. v. Cadtrak Corp., 89 F.3d 673, 677 (9th Cir. 1996) (holding that patent license was "executory contract," because licensor owed "significant continuing performance" to licensee, in that licensor "must continue to refrain from suing [licensee] for infringement . . . .), will often be held to be sufficiently substantial ongoing obligations for the patent license to fall under the Code's definition of "executory contract."

[32] Kuney, *supra* note 3, at 597.

IV. The most important judicial opinion to consider whether federal common law applies to questions of patent license assignability is *Everex*, in which the court concluded that federal common law should apply.

A. The *Erie* doctrine.

We now turn to the choice-of-law question at the core of our legal analysis. As we noted in Part III, in 1852 the Supreme Court created a federal common-law rule, which was meant to supplant state contract law on questions of patent license assignability. In the second half of the nineteenth century and early decades of the twentieth, federal courts consistently used this rule to determine whether patent licenses could be assigned.[33] But the scope of federal common law generally was dramatically narrowed in 1938, with the U.S. Supreme Court's landmark decision in *Erie Railroad v. Tompkins*.[34] On its face, *Erie* seemed to forbid the creation of federal common law (i.e., judge-made law), except when the federal courts were interpreting federal statutes or the Constitution.[35] Thus, federal common-law rules of contract interpretation, such as the traditional one pertaining to patent license assignability, should have been nullified by *Erie*.

But since *Erie* the Supreme Court has considerably re-expanded the scope of federal common law, by carving out a number of exceptions to *Erie*, and today the exact boundaries of

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[33] *See, e.g.*, Troy Iron and Nail Factory v. Corning, 55 U.S. 193, 216 (1852); Oliver v. Rumford Chemical Works, 109 U.S. 75, 83-84 (1883); Hapgood v. Hewitt, 119 U.S. 226, 234 (1886); Lane & Bodley Co. v. Locke, 150 U.S. 193, 195-96 (1893) (dictum); Bowers v. Lake Superior Lake Superior Contracting & Dredging Co., 149 F. 983, 986 (1906).

[34] 304 U.S. 64 (1938).

[35] This is the literal reading of *Erie*'s pronouncement that "[t]here is no federal general common law," 304 U.S. at 78, and that the enforcement of such law exceeded the constitutionally defined powers of the federal courts. Also in *Erie*, the Court made clear that there would no longer be two bodies of substantive law, one to be applied in state courts, the other in federal courts. In the much-narrowed sphere where federal courts retained the power to create judge-made law after *Erie*, that law would be binding on state and federal courts alike.

the federal courts' power to create common law are somewhat murky.[36] The specific question of whether federal common law should apply to questions of patent license assignability has come up in four federal circuit court opinions since *Erie,* and on all four occasions the circuit courts have decided in favor of applying the traditional federal rule. But these four cases hardly establish an overpowering tide of opinion. First, although bankruptcy courts are federal courts and therefore follow federal precedent, it is worth noting that the California State Supreme Court has held that in the post-*Erie* period questions of patent license assignability should be governed by state law, not federal common law.[37] And of the four federal circuit decisions on the topic, only two—*Unarco Industries v. Kelley*[38] and *Everex Systems Inc. v. Cadtrak Corp.*[39]—even attempted to do an *Erie*-style analysis of the proper scope of federal common law. The other two opinions, *Rock-Ola v. Filben*[40] and *PPG Industries v. Guardian Industries*,[41] embraced the federal common-law rule only in dicta, and justified it by simply citing prior federal cases, without discussing whether it made sense to apply the federal common-law rule in the wake of *Erie*. Among the federal cases cited in *Rock-Ola* and *PPG Industries*, the only ones with

[36] *See, generally,* 19 CHARLES ALAN WRIGHT, ARTHUR R. MILLER & EDWARD H. COOPER, FEDERAL PRACTICE & PROCEDURE § 4514, nn.5-38 and accompanying text (2003) (describing existence of myriad post-*Erie* instances of federal common law).

[37] Farmland Irrigation Company, Inc. v. Dopplmaier, 48 Cal. 2d 208, 220 (Cal. 1957). Three of the four post-Erie federal circuit cases were decided after *Dopplmaier,* and there remains the possibility that the California Supreme Court, if confronted with the issue today, would find those three federal-court decisions persuasive on this question of federal Constitutional law concerning the scope of the federal courts' powers. But the *Dopplmaeier* decision is still good law in California, and the fact that its outcome differed from that of the federal circuit courts at least gives one reason to believe the issue is a disputed one.

[38] 465 F.2d 1303 (7th Cir. 1972).

[39] 89 F.3d 673 (9th Cir. 1996).

[40] 168 F.2d 919, 922 (8th Cir. 1948).

[41] 597 F.2d 1090 (6th Cir. 1979). The citing of the federal rule was a dictum because the holding relied on an implied non-assignability term that was ostensibly part of the legal contract; no federal rule was needed to interpret contractual silence because the contact was not silent.

controlling authority (i.e., the only U.S. Supreme Court decisions) had been decided prior to *Erie* itself, and thus could hardly be expected to embody the post-*Erie* state of the law.

Let us examine the two more serious post-*Erie* decisions—*Unarco* and *Everex*—in turn.

B. *Unarco*.

The *Unarco* court supported its decision to embrace federal common law by citing *Sola Electric Co. v. Jefferson Co.*,[42] a Supreme Court case decided four years after *Erie*, in which the Court carved out an exception to *Erie*'s sweeping rejection of federal common law.[43] In particular, the *Unarco* court relied on a passage from *Sola* proclaiming that *Erie*'s ban on federal common law was "'inapplicable to those areas of judicial decision within which the policy of the law is so dominated by the sweep of federal statutes that legal relations which they affect must be deemed governed by federal law having its source in those statutes, rather than by local law.'"[44] The *Unarco* court concluded that questions of patent license assignability did fall into this *Sola*-created exception to *Erie*, and must therefore be controlled by federal common law. As the *Unarco* court put it,

> When [a] . . . person . . . desires to license or relinquish any part of the patent monopoly, such person is utilizing the monopoly of rights intended by the framers of the Constitution and the legislation of Congress to reward invention and originality. This monopoly conferred by federal statute as well as the policy perpetuating this monopoly, so affects the licensing of patents, and the policy behind such licensing is so intertwined with the sweep of federal statutes, that any

[42] 317 U.S. 173, 176 (1942).

[43] 304 U.S. 64, 78 (1938).

[44] Unarco Industries v. Kelley Co., 465 F.2d 1303, 1306 (quoting from *Sola*, 317 U.S. at 174).

question with respect thereto must be governed by federal law.[45]

Thus, the *Unarco* court concluded, "[w]e are of the opinion that the question of assignability of a patent license is a specific policy of federal patent law dealing with federal patent law."[46]

But this invocation of *Sola* was clearly misplaced. Based on the language from *Sola* quoted *supra* at the text accompanying note 44, the *Sola* Court clearly meant to permit the creation of federal common law only in circumstances where a whole "area[] of judicial decision" was densely populated by federal statutes directed toward a particular policy goal, so that the "legal relations" affected by those statutes need to be controlled by federal law. But this cannot possibly justify the *Unarco* decision. Certainly, the law pertaining to the federally created patent monopoly is an "area of judicial decision" that could be regarded as "dominated by the sweep of federal statutes"—namely, the Patent Act. But the *Unarco* decision cannot possibly rest on this observation alone. After all, if we read *Sola* to mean that all "legal relations" affected by the Patent Act must be controlled by federal common law, then federal law would have to eclipse state contract law concerning every conceivable issue of patent license construction, not merely questions of patent license assignability. But in fact, courts routinely treat almost every aspect of patent license construction as a matter of state, not federal law.[47] Thus, as the Ninth Circuit Court of Appeals astutely noted 24 years after *Unarco*, the *Unarco* court's "conclusion [that the *Sola* exception requires patent license assignability to be governed

[45] *Unarco*, 465 F.2d at 1306.

[46] *Id.*

[47] *See, e.g.*, Quinn & Weide, *supra* note 5, at 1143-44 ("The Supreme Court has long held that suits brought on a contract in which a patent is the subject-matter, and which generally do not involve the validity or construction of a patent, are not cases under the patent laws and are within the jurisdiction of the state courts. In addition, the United States Court of Appeals for the Federal Circuit routinely addresses other issues of contract interpretation with state law.).

by federal law] seems insupportably broad given the general rule that most questions with respect to the construction of patent licenses are governed by state law."[48]

C. ***Everex*.**

Because the *Unarco* decision contains this fundamental flaw, we are left with just a single circuit court opinion that can be said to have undertaken a meaningful *Erie* analysis of the patent license assignability question. That opinion came in the *Everex* case, the 1996 decision in which the Ninth Circuit described *Unarco*'s shortcomings before embarking on its own *Erie* analysis. Due to its unique status, *Everex* is likely to serve as the jumping-off point for federal courts confronted with patent license assignability questions in the future, which is why it is such an important decision.

The facts of *Everex* precisely mirror the scenario we have been discussing here. In the events leading up to the litigation, a licensee had declared bankruptcy, and the bankruptcy trustee wanted to assign the (non-exclusive) license to a third party, even though the license itself clearly prohibited assignment. The court concluded (just as we did in Part III) that the question of whether the license could be assigned boiled down to a non-bankruptcy choice-of-law question: Outside of bankruptcy, are issues of patent license assignability governed by federal common law, or not? The *Everex* court's attempt to answer this question is well-summarized in a single paragraph from its decision:

> [] The fundamental policy of the patent system is to "encourag[e] the creation and disclosure of new, useful, and non-obvious advances in technology and design" by granting the inventor the reward of "the exclusive right to practice

[48] Everex Systems, Inc. v. Cadtrak Corp., 89 F.3d 673, 679 (9th Cir. 1996). *See also*, Kuney, *supra* note 3, at 601 ("The notion that 'any question' with respect to the assignment of a patent is a matter of federal common law [, as suggested by the *Unarco* court,] is debatable, and likely to be wrong.")

> the invention for a period of years." Bonito Boats, Inc. v. Thunder Craft Boats, Inc., 489 U.S. 141, 150-51 (1989). Allowing free assignability—or, more accurately, allowing states to allow free assignability—of nonexclusive patent licenses would undermine the reward that encourages invention because a party seeking to use the patented invention could either seek a license from the patent holder or seek an assignment of an existing patent license from a licensee. In essence, every licensee would become a potential competitor with the licensor-patent holder in the market for licenses under the patents. And while the patent holder could presumably control the absolute number of licenses in existence under a free-assignability regime, it would lose the very important ability to control the identity of its licensees. Thus, any license a patent holder granted—even to the smallest firm in the product market most remote from its own—would be fraught with the danger that the licensee would assign it to the patent holder's most serious competitor, a party whom the patent holder itself might be absolutely unwilling to license.

"Thus," the court concluded, "*federal law governs the assignability of patent licenses because of the conflict between federal patent policy and state laws*, such as California's, that would allow assignability."[49] (The "state law" the court is referring to is California contract law.) Having decided that the federal common-law rule should govern questions of patent license assignability generally, the *Everex* court easily concluded that the bankrupt licensee in question should not be allowed to assign its license to a third party, because of Section 365(c) of the Code, which defers to the federal common-law rule, as we saw in Part III.

[49] *Everex*, 89 F.3d at 679 (emphasis added).

V. The existing critiques of *Everex* leave intact much of that case's vitality, but the present argument advances a new critique that goes to the core of the *Everex* court's reasoning.

The considerable scholarship on the treatment of patent licenses in bankruptcy has included several critiques of *Everex*. In a 2001 article discussing patent license assignability in bankruptcy,[50] David R. Kuney points out that the *Everex* court may have simply gotten the state-law rule wrong as it applied to the patent license under consideration. If California contract principles would ordinarily have regarded the relevant patent license as being non-assignable were it not for the no-assign clause,[51] Kuney argues, then the *Everex* court might have been creating an *Erie* issue where none existed. As Kuney notes, "the application of the state law of assignments might well require that the court look to the nature of the contract and endeavor to determine whether the underlying agreement was one where the identity of the parties was actually critical to maintaining the benefit of the bargain,"[52] rather than simply permitting assignment of any contract that is silent on the issue. Indeed, it is true that California contract law does not generally permit the assignment of contract rights when such assignment would materially impair the non-assigning party's chance of getting the performance he expected.[53] This can be seen as an exception to the usual rule of reading contractual silence to favor assignability. (In a 1999 article, Carole A. Quinn and R. Scott Weide made a similar point, to

[50] Kuney, *supra* note 3.

[51] Recall, to pass the Section 365 test, the applicable law must bar assignment with or without the no-assign clause. See Chart 1.

[52] Kuney, *supra* note 3, at 628.

[53] *E.g.*, Farmland Irrigation Co. v. Dopplmaier, 48 Cal. 2d 208, 222 (Cal. 1957).

Kuney's, arguing that the *Everex* court did not carefully consider what outcome would have resulted if California state law had been applied to the license at issue.[54])

It is true that the *Everex* court did not sufficiently defend its assumption that California state law, applied to the particular license before it, would follow the pattern show in the "state law" row on Chart 2. The court does speak of "state laws, such as California's, that would allow assignability"[55] of the license—which suggests that the court had somehow concluded that California law would have followed the "state law" pattern shown in Chart 2, as opposed to the "federal law" pattern, when applied to the particular license in question. The district court below had made it clear that it believed the license would be presumed assignable under California law, and the Ninth Circuit appears to have accepted this view with little additional analysis. But the district court, in turn, rested its conclusion on the California Supreme Court's *Dopplmaier* decision, which it said had dictated that "under California law, patent licenses could be freely assigned"[56]—which is clearly an overbroad reading of *Dopplmaier*.[57] But the reason that neither the Ninth Circuit nor the district court in *Everex* considered the issue carefully is that both courts ended up concluding that, assuming state law *did* favor assignability, the federal common-law rule would trump state law and the bankrupt licensee could not assign—the very same result as if

[54] *See* Quinn & Weide, *supra* note 5, at 1143 ("Neither the Unarco nor Everex court examined what outcome would result if the law of the forum state were applied. Application of state law might have resulted in an outcome identical to that arising from application of the federal rule.").

[55] Everex Systems, Inc. v. Cadtrak Corp., 89 F.3d 673, 679 (9th Cir. 1996).

[56] In re CFLC, Inc., 174 B.R. 119 (N.D. Cal., 1994).

[57] In fact, *Dopplmaier* did not conclude that patent licenses are *generally* presumed assignable absent a no-assign clause. Rather, *Dopplemaier* applied the usual California standard described *supra* at note 53 and the accompanying text, looking at whether assignment would materially impair the non-assigning party's chance of getting the performance he expected, and presuming the license to be assignable only if it would not. *Dopplmaier*, 48 Cal. 2d at 222-24.

state law did not favor assignability.[58] In short, the fine points of California state law were not outcome-determinative given the holding, so the district court and Ninth Circuit did not focus on them.

But even if one can quarrel with the application of California state contract law to the particular license at issue in *Everex*, this does nothing to assail *Everex*'s main result: that in cases where state law and federal common law differ on how a patent license should be treated, the latter wins out, even in the post-*Erie* world. At the very least, we know there are *some* circumstances in which state-law doctrines like California's would follow the pattern of the "state law" row in Chart 2. We know this because, in *Dopplmaier* itself, the California Supreme Court applied California law to a patent license—a license thatwa s silent on the question of assignability. And in that case the California Supreme Court concluded that "[t]he assignment [of the license in question] did not impair materially [the licensor's][59] chance of obtaining the performance for which [it had] bargained, and therefore it was effective to transfer [the licensee's] rights to" the assignee.[60] In other words, the California Supreme Court applied ordinary state contract law to a patent license that was silent on the issue of assignability, and concluded that this silence should be construed in favor of the proposed assignment—the very definition of the "state law" row in Chart 2.

In the future, whenever such a case arises—i.e, a case where state law would favor assignability of a patent license in the face of contractual silence—courts will presumably override state law, and enforce the opposite result, due to the *Everex* decision. And therefore,

[58] *See* In re CFLC, Inc., 174 B.R. at 124 ("[t]he bankruptcy court properly applied a longstanding rule of federal law . . . ").

[59] Technically, the court was speaking of the assignee of the licensor here. But the difference is unimportant for our purposes.

[60] Farmland Irrigation Co. v. Dopplmaier, 48 Cal. 2d 208, 223-24 (Cal. 1957).

whenever a bankrupt licensee tries to assign a patent license that contains a clear no-assign clause, such assignmentwill be forbidden under Section 365(c) of the Code, even when that license, absent its no-assign clause, would be assignable under ordinary state law. Thus Kuney's critique of *Everex*—because it is limited to the particulars of how the *Everex* court applied California state law to the license at issue—does not undermine the future influence of the *Everex* opinion. It is at best a fact-specific critique.

In their 1999 article, Quinn & Weide[61] launched a second assault on *Everex*. They pointed out that in 1952, when Congress voted the Patent Act into law,[62] it must have been aware of the various decisions concerning patent license assignability, yet it chose not to address patent licenses directly anywhere in the Act.[63] Indeed, even after 1957, when the California Supreme Court, in *Dopplmaier*, held that state contract law governs issues of patent license assignability after *Erie*,[64] Congress failed to revise the Patent Act to overrule *Dopplmaier*. Quinn & Weide interpret this persistent inaction by Congress as evidence that there is no *Everex*-style "federal policy" urging us to protect the value of the patent monopoly in all cases.[65] If there were such a

[61] *See* Quinn & Weide, *supra* note 5.

[62] 35 U.S.C. §§ 1-376.

[63] *See* Quinn & Weide, *supra* note 5, at 1142-43 (". . . while Congress was aware of the various decisions regarding patent license transferability when it enacted 35 U.S.C. § 261 in the 1952 Patent Act, it did not amend this section to clarify the rights of a licensee."). It is clear from the context that Quinn & Weide mean that Congress did not "amend" the various pre-enactment drafts to clarify this issue. *See also Dopplmaier*, 48 Cal. 2d at 220, noting that "[patent] [l]icenses have no [federal] statutory basis . . . ."

[64] *See Dopplmaier*, 48 Cal. 2d at 220 ("If any federal interest exists, it is too remote and speculative to justify displacing state law. We conclude, therefore, that we are free to make our own determination whether the assignability of a license contract requires express consent in the contract.") (citation omitted).

[65] *See* Quinn & Weide, *supra* note 5, at 1142 (noting that "[t]he fact that the particular rights at issue are government granted "exclusive" rights does not support a finding that there must be a federal policy which serves to always protect the rights," and invoking Congressional inaction as evidence to support this).

federal policy, Quinn & Weide reason, Congress would surely have written protections for patent licenses into the Patent Act.

But the very same history can be invoked to support the opposite conclusion. When Congress enacted the Patent Act in 1952, it could have pointed to a century's worth of federal decisions holding that the federal common-law rule, and not state law, applied to patent license assignments.[66] And if there was any doubt about whether the federal rule had survived *Erie*, the 1952 Congress could have easily looked to the, post-*Erie,* 1948 Eighth Circuit decision in *Rock-Ola v. Filben*,[67] which had re-asserted the federal rule in the wake of *Erie* (though, as noted above, the relevant language had appeared in dicta[68]). In other words, to the extent that the 1952 Congress held any belief at all about the law on patent license assignability, it was probably that such matters were already governed by federal common law. Thus, Congress's failure to mention patent licenses in the Patent Act might be taken as a sign that it approved of the traditional, federal common-law, treatment of those licenses.

And what of Congress's failure to overrule *Dopplmaeir*? This, too, admits to a different reading than Quinn & Weide's. On both occasions when Congress was revising the relevant section of the Patent Act,[69] in 1975 and again in 1982,[70] it already would have known about the 1972 decision in *Unarco*, clearly stating (and not in dicta this time) thatfederal common law controlled questions of patent license assignability, even post-*Erie*. Here, again, one can interpret Congress's inaction as tacit *approval* of the use of federal common law, rather than as

[66] The federal common law rule was created in 1852 in Troy Iron and Nail Factory v. Corning, 55 U.S. 193 (1852), and had been repeatedly invoked by federal courts since that time.

[67] 168 F.2d 919, 922 (8th Cir. 1948).

[68] *See id.* (noting that the license at issue explicitly forbade the assignment in question).

[69] The obvious section in which to overrule *Dopplmaier* is Section 261 of the Patent Act, which is entitled "Ownership; assignment."

[70] Quinn & Weide, *supra* note 5, at 1143.

tacit disapproval, as urged by Quinn & Weide. Ultimately, this game of divining meaning from Congressional silence leads, at best, to a stalemate.[71]

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This article distinguishes itself from these previous efforts to attack *Everex*, in that it meets the *Everex* opinion on its own terms. Here, we do not quarrel with the *Everex* court's skill in applying California state contract law to the license before it, nor do we take issue with the court's assertion that there is a federal policy favoring the preservation of the value of the patent monopoly, at least to some degree. Here, we *assume* that the patent license at issue in *Everex* would have been presumed assignable under California law—i.e., would have followed the "state law" pattern on Chart 2. And we take *Everex* at its word that "[t]he fundamental policy of the patent system is to 'encourag[e] the creation and disclosure of new, useful, and non-obvious advances in technology and design' by granting the inventor the reward of 'the exclusive right to practice the invention for a number of years,'"[72] and that this implies some federal interest in maintaining the economic value of the patent monopoly.

But even if one grants the *Everex* court these core assumptions, its opinion is still susceptible to attack. And it is this effort to attack *Everex* on its own terms that is the main project of this article. As we will see in the next section, *Everex*'s own logic does not necessarily lead to the conclusion that federal common law should control questions of patent license

[71] A similar critique can be made of Jessica Braeger's 2002 Note in the Drake Law Review, asserting that "[i]f Congress meant to preempt state contract law as it applies to patent license agreements with § 261, it would have done so more directly." Braeger, *supra* note 5, at 652-53.

[72] Everex Systems, Inc. v. Cadtrak Corp., 89 F.3d 673, 679 (9th Cir. 1996), quoting from Bonito Boats, Inc. v. Thunder Craft Boats, Inc., 489 U.S. 141, 150-51 (1989).

assignability post-*Erie*. To properly draw *that* conclusion, the *Everex* court would have had to first find that licensee bankruptcy was, empirically, a high-probability event. And neither *Everex* nor its previous critics have even acknowledged that such an empirical finding was relevant.

VI. The *Everex* court found a significant conflict between federal patent policy and the use of state contract law only by assuming, incorrectly, that every patent license in the United States ends up in the hands of a licensee that goes bankrupt.

A. The *Everex* court's core error: its failure to consider the probability of licensee bankruptcy.

Because the *Erie* decision was a Supreme Court edict against the creation of federal common law, lower courts can endorse the use of federal common law only by pointing to an exception to *Erie* carved out by the Supreme Court itself. The *Everex* court relied on a different exception to *Erie* than the *Sola*-created exception cited in *Unarco* (and discussed in Section IV.B above). The exception invoked by *Everex* is one that permits the use of federal common law in cases where following state law would significantly conflict with some federal policy. To establish that exception, the *Everex* court cited the Supreme Court case of *Lear v. Adkins*.[73] From *Lear*, the *Everex* court drew the proposition that "[t]he construction of a patent license is generally a matter of state contract law [], except where state law 'would be inconsistent with the aims of federal patent policy,' []."[74] The *Everex* court then used this "federal policy" exception to *Erie* to justify adopting the federal common-law rule for questions of patent license assignability.

Let us examine *Lear* for a moment, to better understand the *Erie* exception invoked by the *Everex* court. In *Lear*, the Supreme Court was asked to decide how a certain patent license should be construed. "The decisive question," the Court said, was "whether overriding federal policies would be significantly frustrated" if state contract law were applied.[75] By invoking *Lear*, the *Everex* court revealed that it was relying on the *Erie* exception invoked in *Lear*—the

[73] 395 U.S. 653 (1969).

[74] *Everex*, 89 F.3d at 677 (parenthetical, citations to *Lear*, 395 U.S. at 661-62 & 673, and additional citations, omitted).

[75] *Lear*, 395 U.S. at 673.

one allowing the use of federal common law when applying state law would significantly conflict with some federal policy. As we saw in Section IV.C, the *Everex* court ended up concluding that federal common law must govern the assignability of patent licenses, "because of the conflict between federal patent policy and state laws, such as California's, that would allow assignability."[76]

At the time of the *Everex* decision, this same exception to *Erie* had been restated by the Supreme Court in at least two cases following *Lear*. In *O'Melveny & Myers v. Federal Deposit Insurance Corporation*, a decision also noted with approval in *Everex*, the Supreme Court explained that exceptions to the *Erie* doctrine are "limited to situations where there is a 'significant conflict between some federal policy or interest and the use of state law.'"[77] Similarly, in *Boyle v. United Technologies Corporation*, the Supreme Court explained that federal judges may create federal common law when "a 'significant conflict' exists between an identifiable 'federal policy or interest and the [operation] of state law . . . ."[78]

Having reviewed the relevant Supreme Court cases, we can now state the logic of *Everex* more precisely. *Everex* concluded that applying state contract law to questions of patent license assignability would "undermine the reward that encourages invention," thus "significantly conflicting" with federal patent policy. And because of Supreme Court cases such as *Lear*, *O'Melveny* and *Boyle*, we know that, when the use of state law would significantly conflict with federal policy, it is proper to supplant state law with federal common law. On its face, then, the

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[76] *Everex*, 89 F.3d at 679.

[77] 512 U.S. 79, 87 (1994) (quoting Wallis v. Pan American Petroleum Corp., 384 U.S. 63, 68 (1966)).

[78] 487 U.S. 500, 507 (1988). In fact, only *O'Melveny* is a perfect analog to *Lear*. *Boyle* did apply the "significant conflict" standard, but the Court first determined that the relevant area of law (that of military contracting) was one of "uniquely federal interest." Therefore, the "significant conflict" did not have to be as significant as it would otherwise have needed to be, to permit the use of federal common law. *Id.* at 507-08.

Everex decision appears to be a perfectly reasonable implementation of the "significant-conflict-with-a-federal-policy" exception to *Erie*. But a closer look reveals an important elision in the *Everex* court's reasoning—one that might have led the court to the wrong result.

The *Everex* court is saying that if we were to allow state common law to control, many states would (as California has done) impose a rule favoring assignability—i.e., one following the "state law" pattern in Chart 2. And because of the details of Section 365 of the Bankruptcy Code, this would mean that a bankrupt licensee could assign its license to a third party, even when the license contained a clear no-assign clause. Undermining no-assign clauses in this way surely does reduce the value of the patent monopoly to its holder—or, as the *Everex* court put it, "undermine[s] the reward that encourages invention." Therefore, it significantly conflicts with federal policy, and must not be permitted.

But this logic, straightforward as it seems, overlooks an important fact of life—namely, that most patent licensees *do not wind up in bankruptcy*. To decide that federal common law should govern questions of patentlicense assignability, the *Everex* court first had to conclude that the use of state law would significantly frustrate federal patent policy. In reaching this conclusion, the court noted that great harm would be inflicted on the patent monopoly if state law were used, because bankrupt licensees would be able to ignore no-assign clauses in their licenses. But the court failed to account for the fact thatmany patent licensees do not go bankrupt, and in all of those cases state law gives *the very same result as the federal common-law rule*. Outside the special context of bankruptcy, the Code does not apply, and there is no need for the complex dance of Section 365. Outside bankruptcy, whether one is using state law or federal common law, the no-assign clause is honored and the licensor is not harmed in the least. (To see this, notice that the right-hand column of Chart 2 says "assignment not permitted" under both the federal and state rules.)

When a court calculates how badly the use of state law would impair the incentive to innovate, it must view the problem from the perspective of the would-be innovator: the inventor sitting in his laboratory (or, perhaps more realistically, the R&D director sitting in her office), trying to decide how much effort, time, or money to invest in a certain research project. This decision is made long before the invention is complete, long before the patent is issued, and certainly long before the inventor learns whether the eventual licensee of that patent will end up going bankrupt. From the *ex-ante* perspective of the innovator, the chances may be small that the licensee will ever declare bankruptcy. And from the innovator's point of view, it will only be in these rare cases that the no-assign clause will be undermined by state law. This small chance of having the no-assign clause undermined might not reduce the *ex-ante* expected value of the patent monopoly by very much at all, because it counts for little in the calculation of the overall *average* expected future value of the patent. If licensee bankruptcy is very unlikely, then the innovator's incentive to innovate would scarcely be affected by this very improbable cataclysm.

It is as if the innovator is being promised the keys to a Rolls Royce if he discovers a useful, new and non-obvious technology, and Section 365 of the Code is imposing a one-in-a-thousand chance that the Rolls Royce he wins will be a lemon. This small chance of winding up with a worthless Rolls Royce will scarcely dampen the innovator's incentive to work hard at his research, because there is still a 999-in-a-thousand chance that the Rolls Royce will be an extremely valuable "non-lemon."

The *Everex* court appears to have gotten distracted by the fact that the particular licensee before it happened to be in bankruptcy. When the court inquired into how seriously the application of state law would frustrate federal patent policy, it behaved as if state law would routinely frustrate no-assign clauses in patent licenses. In the court's words, "Allowing free assignability . . . would undermine the reward that encourages invention because . . . [i]n essence every licensee would become a potential competitor . . . in the market for licenses . . . ." But this is plainly false. It is not "every licensee" that can freely assign his license to a third party: It is only *bankrupt* licensees who can do so. Non-bankrupt licensees must obey the no-assign clause under both the state and federal rules. And the would-be innovator must surely factor these "good outcomes" into her calculation of the *ex-ante* expected value of the patent.

As an example, suppose that exactly 1% of the nation's patent licenses are granted to licensees destined to wind up in bankruptcy.[79] In that case, even if undermining a license's no-assign clause literally reduced its value to the licensor to *zero* (which, of course, it does not), it would still be the case that applying state contract law as opposed to federal common law could not possibly reduce the *ex-ante* value of a patent by more than one part in a hundred.[80]

What's more, if our hypothetical assumption is correct—i.e., if only 1% of the nation's licensees wind up in bankruptcy—then the *Everex* court may be subjecting the remaining 99% of

[79] A more complete analysis would have to look not simply at the fraction of the licenses whose licensees declared bankruptcy, but rather at the value-weighted fraction of licenses whose licensees did so. For instance, if 1/3 of licenses wound up in bankruptcy, but all of them turned out to be licenses for nearly worthless technologies, then the would-be innovator might not particularly care. Having one's no-assign clause stripped away by the courts only smarts if the underlying technology has real value.

[80] This statement is only approximately accurate. In fact, while the expected value of the patent cannot decline by more than one part in 100, the actual value of the patent to the innovator can decline by slightly more than that. Generally speaking, risk-averse people are not willing to pay an asset's expected value to acquire the asset, if the risk of the asset is non-diversifiable, because the people will insist on some discount for the hardship of bearing the risk itself. For instance, a gamble that promises a payoff of $2 half the time, and $0 the other half, is worth less than $1, due to the cost of uncertainty itself (and perhaps also due to the declining marginal utility of money). This idea is fundamental to finance theory. If the expected probability of bankruptcy is small, however, this correction for the cost of risk-bearing will be small as well, and the statement above, that "applying state contract law rather than federal common law could not possibly reduce the ex-ante value of a patent by more than one part in 100," will be approximately correct.

the licensees to federal common law, thus stripping state legislatures and state courts of their *Erie*-vouchsafed powers, merely to avoid a bad result in that one-in-a-hundred case where the licensee happens to go bankrupt. This would be a startling example of the tail wagging the dog. The point of this article is not to claim that only 1% (. . . or 2%, or 7%) of the nation's patent licensees wind up in bankruptcy. Your author does not know the actual figure. The point is simply to assert that the *Everex* court made no finding at all on this critical empirical question. Had it looked into the matter, and concluded that only a small fraction of patent licensees go bankrupt, the court's decision might well have gone the other way, even using the very same legal analysis.

Another way of viewing the problem is to start with the Coase Theorem, which tells us that a licensee and licensor will choose the contractual terms that maximize the total economic value of the patent at the time the license is signed. If they choose to put a no-assign clause in the license, it is likely because a non-assignable license preserves more of the patent's total economic value than an assignable one would have done. Therefore, any rule of law that nullifies no-assign clauses (provided that these clauses arise out of free and well-informed bargaining) reduces the total economic value of the patent.[81] By nullifying the no-assign clause when the licensee is in bankruptcy, the use of state law therefore clearly reduces the patent's *ex*-

[81] As discussed in Part II, such a rule amounts to a requirement that the licensor must sell the licensee a kind of "bankruptcy insurance" along with the license. A non-assignable patent license that becomes assignable only in the case of licensee bankruptcy is equivalent to a purely non-assignable license plus an insurance policy in which the licensor pays the licensee a large sum only if the licensee happens to go bankrupt. The cost of this "insurance" will be built into the fee structure of the patent license. Clearly, there may be some moral hazard problems with such an insurance policy, and even if such insurance were desirable there is no reason to believe the patent licensee is well-positioned to bear the associated risk (as opposed to, say, an insurance company or other financial institution that can diversify it). Thus, the rule that a no-assign clause is nullified in the case of licensee bankruptcy distorts the market for patent licenses, away from the terms that would result from unconstrained bargaining.

ante value. What the *Everex* court failed to consider is that it mightreduce the patent's value only very *slightly*, not "significantly," because licensee bankruptcy may, in fact, be quite rare.

B. **The U.S. Supreme Court has made the same argument in another context: *Robertson v. Wegmann*.**

A close analog to the above argument can be found in the Supreme Court's decision in the 1978 case of *Robertson v. Wegmann*.[82] There, a plaintiff had sued a state district attorney and others under 42 U.S.C. § 1983, claiming that his federal civil rights had been violated under color of state law. Section 1983 specifically requires that courts use the statutes of the forum state to fill legal gaps in the federally created private right of action for civil-rights violations, except where such state laws are"incon sistent with the Constitution and laws" of the United States.[83] In such cases, by implication, federal common law must be used. Thus, the standard for when to apply federal common law in Section 1983 actions differs slightly from the *Everex*-invoked standard calling for a "significant conflict" between state law and federal policy. Still, in *Robertson v. Wegmann*, the Supreme Court explained that in looking for "inconsistencies" between state and federal law, "courts must look not only at particular federal statutes [], but also at 'the policies expressed in [them].'"[84] "Of particular importance," said the Court, "is whether application of state law 'would be inconsistent with the federal policy underlying . . .'" Section 1983.[85] Thus, the test actually used by the Supreme Court in *Robertson v. Wegmann* ends up being quite similar to the "significant-conflict-with-a-federal-policy" test used in *Everex*.

In *Robertson v. Wegmann*, the Section 1983 suit had been brought in a Louisiana state court. The plaintiff had died before the planned trial, and the executor of his estate had

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[82] 436 U.S. 584 (1978).

[83] *Id.* at 587.

[84] *Id.* at 590 (citation omitted).

[85] *Id.* (citation omitted).

attempted to continue his civil-rights action on the estate's behalf. But Louisiana's survivorship statute would allow the suit to go forward only if it was brought on behalf of the plaintiff's spouse, children, parents or siblings, and no such relatives existed. Thus, the federal cause of action would have abated with the plaintiff's death, unless the federal courts were allowed to impose a federal common-law rule providing that a Section 1983 action survives in favor of the plaintiff's estate.[86]

The Court acknowledged that the federal "policies underlying § 1983 include compensation of persons injured by deprivation of federal rights and prevention of abuses of power by those acting under color of state law."[87] But in the end, the Court found that the Louisiana survivorship law, not federal common law, should control, because use of the state statute did not frustrate these policies seriously enough to warrant the use of federal common law. "[G]iven that most Louisiana actions survive the plaintiff's death," the Court wrote,

> the fact that a particular action might abate surely would not adversely affect § 1983's role in preventing official illegality . . . . A state official contemplating illegal activity must always be prepared to face the prospect of a § 1983 action being filed against him. In light of this prospect, even an official aware of the intricacies of Louisiana survivorship law would hardly be influenced in his behavior by its provisions.[88]

The analogy with *Everex* is clear. Due to the Louisiana state survivorship rule, a small number of valid civil-rights actions would die with the plaintiff, whereas under federal common law they would have survived him. The case before the Court in *Robertson v. Wegmann*

[86] *Id.* at 588.

[87] *Id.* at 591 (citations omitted).

[88] *Id.* at 592.

happened to be one of these rare cases.[89] Thus, it is beyond dispute that the Louisiana statute reduces the average cost of committing a civil rights violation under color of state law, from the perspective of the would-be violator. But, as the *Robertson v. Wegmann* Court observed, because *very few* plaintiffs will die before trial leaving behind neither spouse, child, parent nor sibling, the cost of committing such a civil-rights violation—from the *ex-ante* perspective of the would-be civil-rights violator—will decline only *slightly* due to the use of the Louisiana rule. Therefore, in the Court's words, "even an official aware of the intricacies of Louisiana survivorship law would hardly be influenced in his behavior" by the use of the state rule.

This article has made the same basic argument regarding *Everex*. The use of state law to decide questions of patent license assignability does, indeed, reduce the value of the patent monopoly when the licensee is bankrupt. But if licensee bankruptcy is relatively rare, then the incentive to innovate, from the *ex-ante* perspective of the would-be innovator, would hardly be dampened at all by the use of state law, just as the incentives of the would-be civil rights violator would have scarcely been affected by the use of the Louisiana survivorship rule in *Robertson v. Wegmann*. Unlike the Supreme Court in *Robertson v. Wegmann*, the Ninth Circuit in *Everex* failed to address the critical empirical issue of how *frequently* the situation arises in which state law conflicts with the relevant federal policy.

[89] "Happened to be" is perhaps too glib. It is often the doctrinally problematic case, not the typical one, which makes it to court—especially to the federal appellate courts and the U.S. Supreme Court. This is one reason why courts must guard against presuming that the facts before them are representative, as the Ninth Circuit seems to have done in *Everex*.

VII. The most powerful critiques of the argument being advanced in this article turn out, on closer inspection, not to detract from its main thesis.

Built into the logic of this article are some assumptions about the *Erie* exception that was invoked by the *Everex* court, and about how the court applied that exception to the facts before it. In this Part VII, we anticipate three particular concerns readers might have regarding these assumptions, and show that they do not undermine this article's main argument. <u>This Part covers ideas that are sometimes subtle, and it can be skipped on a first reading</u>. Its main purpose is to address questions that might arise in the minds of some readers.

A. <u>The "significant conflict" test imposes a meaningful quantitative threshold on the severity of the conflict with federal law</u>.

This article has argued that the *Everex* court's critical error was failing to consider the probability of licensee bankruptcy. If this probability is low, then perhaps the use of state law to decide questions of patent license assignability does not "significantly conflict" with federal policy, even though it may conflict to some small degree. One might reasonably wonder whether this argument fixates unduly on the word "significant" in the *Erie* line of cases. Can we really defend the notion that a conflict between state law and federal policy must surpass some quantitative threshold—that it be "significant"—before courts can cure the problem by imposing federal common law? In fact, we can.

First, in the Supreme Court's statements of the legal standard, the word "significant" is always used. In *Lear*, the Court held that "[t]he decisive question" is "whether overriding federal policies would be significantly frustrated" by the use of state law, and in *O'Melveny* and *Boyle* the Court explained that federal common law was permitted when there was a "significant conflict" between federal policy and the use of state law.[90] Other authors have explicitly recognized the quantitative nature of the "significant conflict" standard. Quinn & Weide have noted that "even assuming a conflict between state law and [the relevant] federal policy were to exist [in the *Everex* case], the conflict must be significant in order to justify displacement of state law."[91]

The ascription of real meaning to the word "significant" in the Supreme Court doctrine can also be defended on the grounds of common sense. The *Erie* decision created a strong presumption against the use of federal common law, and the Supreme Court has "emphasized that federal common law can displace state law in 'few and restricted' instances."[92] If courts were unwilling to tolerate even a small conflict between federal policy and the use of state law, they would find themselves displacing essentially all state laws with federal common law. For any given state-law doctrine, one can always dream up an unlikely set of events that would render the state doctrine inimical to federal policy. But if such events are extremely unlikely, it cannot be said that the use of state law *significantly* frustrates federal policy overall; so there is no need to unseat state authority.

The Supreme Court has also, on occasion, explicitly acknowledged the quantitative threshold that characterizes the "significant conflict" test. In *Boyle* the Court explained that in an area of "uniquely federal interest" (in this case, military contracting) the Court would still require a "significant conflict" before imposing federal common law, but noted that "[t]he conflict [of state law] with federal policy need not be as sharp as that which must exist for [the sort of] . . .

[90] *Supra* notes 77 & 78 and accompanying text.

[91] Quinn & Weide, *supra* note 5, at 1143.

[92] Boyle v. United Techs. Corp., 487 U.S. 500, 518 (1988) (quoting from Wheeldin v. Wheeler, 373 U.S. 647, 651 (1963)).

pre-emption" used in *Everex*.[93] In other words, in areas of uniquely federal interest, the conflict with federal policy need not reach as high a "level" as in *Everex*-type cases, before triggering the use of federal common law[94]—a logic that implicitly acknowledges some quantitative threshold. Similarly, in 1992 a federal district court applying the same standard used in *Boyle* found that the use of state law "does not present a sufficiently significant conflict between federal and state law" to justify the use of federal common law,[95] another implicit recognition that not just any conflict will do. Thus, the "significant conflict" standard invoked by the *Everex* court does impose a meaningful floor on the severity of the conflict. In particular, if licensee bankruptcy is sufficiently unlikely, the conflict created by the Code's nullification of no-assign clauses may not be significant enough to warrant the use of federal common law.

[93] *Id.* at 507.

[94] In the case of *Chapman v. Westinghouse Electric Corp.*, 911 F. 2d 267, 269 (1990), the Ninth Circuit itself acknowledged that *Boyle* called for a reduced threshold for a "significant conflict." ("[Appellant] vigorously contends, however, that even given the lesser degree of conflict required for preemption in areas of uniquely federal interest, the limitation of liability policy expressed in the Act does not pose a 'significant conflict,' [] with the operation of state law . . . ." (citing *Boyle*, 487 U.S. at 507)).

[95] Illinois Psychiatric Hospital Co. v. Health Care Services Corp., 1992 U.S. Dist. LEXIS 9607, *7. The Supreme Court's 1994 decision in *O'Melveny & Myers v. Federal Deposit Insurance Corp.*, 512 U.S. 79 (1994), which was cited by the *Everex* court for its "significant conflict" standard, also invokes the quantitative threshold, albeit indirectly. In *O'Melveny* the Court had to decide whether a state-law rule imputing to a corporation the knowledge of its officers, even if the officers were acting against the corporation's interests, should be overridden by federal common law. (Using the state rule would have estopped the FDIC from suing a law firm for professional negligence in its work for a failed savings-and-loan.) Among other things, the Court considered one party's assertion that federal common law should apply to *all* questions of imputing officers' knowledge to corporations when the officers are acting against the corporation's interests. *O'Melveny*, 512 U.S. at 83. But the Court easily concludes that such a broad use of federal common law would be "plainly wrong." "[T]he remote possibility that that corporations may go into federal receivership," the Court wrote, "is no conceivable basis for adopting a special federal common-law rule divesting States of authority over the entire law of imputation." *Id.* Here, as in *Robertson v. Wegmann*, the Court refuses to impose federal common law on a wide swath of cases, when the use of state law would harm the relevant federal interest in only a small fraction of those cases.

O'Melveny illustrates how the main point of this paper can be viewed as an argument for the "narrow tailoring" of federal common law rules: If a court is going to supplant state law with federal common law, it must do so in a universe of cases which is narrow enough that, when considered over the whole range of these cases, the application of state law would "significantly" impair a federal policy.

B. **<u>The *Everex* court relied on a significant conflict with actual California contract law, not with a hypothetical law that California might someday enact</u>.**

We should also briefly address a potential misreading of *Everex* that might, if it were correct, undermine the argument of this article. The *Everex* court found that "[a]llowing free assignability—or, more accurately, allowing states to allow free assignability—of nonexclusive patent licenses would undermine the reward that encourages invention . . . ."[96] The phrase "allowing states to allow free assignability" suggests that perhaps the court was not claiming that California state law *actually* created a significant conflict with federal patent policy, but simply that leaving the matter in the hands of the states could *conceivably* pose such a conflict in the future. To take an extreme example, the California legislature might someday enact a law declaring that "all contracts are hereby assignable, regardless of any no-assign clauses they might contain." Such a hypothetical law would, of course, frustrate no-assign clauses in patent licenses, not only in cases of licensee bankruptcy, but 100% of the time. Thus the "significant conflict" threshold would clearly be surpassed.[97]

But there is ample evidence that the *Everex* court was *not* referring to such "hypothetical state law." The easiest way to see this is by looking at the language of *Everex* itself. The court concludes its discussion of whether federal common law should be applied as follows: "Thus, federal law governs the assignability of patent licenses because of the conflict between federal patent policy and state laws, such as California's, that would allow assignability."[98] The phrase "such as California's" strongly suggests that the basis for the court's decision was the conflict

[96] Everex Systems, Inc. v. Cadtrak Corp., 89 F.3d 673, 679 (9th Cir. 1996),

[97] I thank Prof. Barry Adler of New York University School of Law for pointing out this possible alternative reading of *Everex*, and providing this extreme example.

[98] *Everex*, 89 F.3d at 679.

with federal policy posed by the *actual* law of the State of California, not by some hypothetical law the state might enact in the future.

A review of the relevant Supreme Court cases shows that, in applying the "significant conflict" test, the Court always focuses on the actual law of the forum state, not on hypothetical law. For instance, in *Wallis v. Pan American Petroleum Corp.*,[99] the court below had found a significant conflict between Louisiana state law and the federal policy of promoting the assignability of certain mineral leases. The Supreme Court disagreed. "However fitting [the lower court's] approach may be where a State interposes unreasonable conditions on assignability," the Court wrote, "it can have no force in this instance because Louisiana concededly provides a quite feasible route for transferring any mineral lease . . . ."[100] Thus, while state law could have *hypothetically* created a significant conflict with the federal policy, the use of federal common law was not warranted because the *actual law* of Louisiana did not conflict seriously enough with federal policy to justify such an extreme measure. The test, then, is whether the actual law of the forum state conflicts significantly with a federal policy, not whether some future law might do so. The ostensible conflict found by the *Everex* court was one presented by the actual state contract law of California. I.e., this article's reading of *Everex* has been correct.

C. We have been considering only licenses that contain a no-assign clause, but even if the *Everex* court meant to consider all possible patent licenses, the shortcomings of its analysis are unchanged.

Our discussion thus far has been based on the notion that the harm to the value of the patent monopoly, which the *Everex* court cited as justifying the use of federal common law, occurs only when the license contains a no-assign clause, which is overridden by Section

[99] 384 U.S. 63 (1966).

[100] *Id.* at 69-70.

365(f)(1) of the Code. But perhaps *Everex* can be read more broadly. Consider what would happen if the license we are dealing with is *silent* on the issue of assignability. In that case, the use of state law (rather than federal law) would result in the patent license being assignable as well. If most patents are worth more when subject to non-assignable licenses, then construing these "silent" licenses to be assignable will reduce the expected value of the patent on average. The following chart may help clarify this point.

	License says "licensee may assign"	**License is silent on assignability**	**License says "licensee may not assign"**
Licensee is bankrupt	Federal law: **may assign** State law: **may assign**	Federal law: **may not assign** State law: **may assign**	Federal law: **may not assign** State law: **may assign**
Licensee is not bankrupt	Federal law: **may assign** State law: **may assign**	Federal law: **may not assign** State law: **may assign**	Federal law: **may not assign** State law: **may not assign**

<u>Chart 3</u>. There are three situations (the shaded boxes above) in which the use of state law, rather than federal common law, to decide questions of patent license assignability might impair the value of the patent monopoly. We have been paying attention to only one (the cross-hatched box). Here, we consider all three.

In all three of the shaded boxes in Chart 3, the federal rule prohibits assignment while the state rule allows it. Thus, in all three regions, the use of state law will tend to conflict with federal patent policy. In the above discussion, we have focused only on the cross-hatched region—the one in which an explicit no-assign clause is overridden by the Code. Perhaps, viewed from the *ex-ante* perspective of the innovator, the expected harm to the patent's value done by all three of the shaded boxes (each weighted by its probability of occurrence) is enough to make state law "significantly conflict" with federal policy, even though the harm due to the cross-hatched box alone does not reach the "significant conflict" threshold.

In fact, there is language in the district court opinion in *Everex* suggesting that the lower court may have had all three shaded boxes in mind. The district court remarked that "[l]imiting assignability to licenses in which the patent holder expressly agrees to assignment aids the patent holder in exploiting the patent."[101] This makes it sound as if the district court was considering the impact of state law over the whole range of possibilities, including licenses that are silent about assignability.

But the Ninth Circuit in *Everex* seems to have been thinking only of the cross-hatched box. "As a practical matter," the court wrote,

> free assignability of patent licenses might spell the end to paid-up [i.e., flat-fee,] licenses. . . . Few patent holders would be willing to grant a license in return for a one-time lump-sum payment, rather than for per-use royalties, if the license could be assigned to a completely different company which might make far greater use of the patented invention than could the original licensee."[102]

This language conveys the distinct impression that the court was thinking of the harm done to patent holders who *know* beforehand that they would like to create a non-assignable license, and thus presumably would have inserted a no-assign clause, but who are scared off by the fear that the licensee will go bankrupt.

More fundamentally, even if the Ninth Circuit had been thinking of the harm to federal policy found in all three shaded boxes of Chart 3, the argument of this article still holds up. From the *ex-ante* perspective, the innovator still must assess the likelihood that the situations

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[101] In re CFLC, Inc., 174 B.R. 119, 123 (N.D. Cal., 1994).

[102] Everex Systems, Inc. v. Cadtrak Corp., 89 F.3d 673, 679 (9th Cir. 1996).

described by the three shaded boxes will come to pass, in order to figure out the expected value of his patent. But if the *Everex* court did not even weigh in on the likelihood of the license ending up in the cross-hatched box, it *certainly* did not speculate about the probability of its landing in *any* of the three shaded boxes. The point remains the same: The target of the incentive—the would-be innovator—must evaluate an array of future scenarios, in only some of which the use of state law will reduce the value of the patent. And the degree to which this innovator's incentive is dampened will depend on the relative probabilities of the patent-value-reducing scenarios and the patent-value-preserving ones. The *Everex* court did not even begin to make such an empirical assessment.[103]

[103] Indeed, the addition of the extra two shaded boxes should not substantially affect the outcome of the analysis. In any situation where a patent would be more valuable with a no-assign clause, a licensor will "forget" to include a no-assign clause (i.e., will end up in the middle column of Chart 3) only if the expected value of the patented technology is very small.

VIII. What courts should do when faced with *Everex*-type questions in the future.

Undoubtedly courts will continue to face fact patterns similar to those found in *Everex*. It is therefore worth considering how these future courts might avoid the pitfalls of the *Everex* court's reasoning. Any future court faced with such a problem would likely arrive at the same conclusion we ended up with in Part III: Bankrupt licensees may assign their licenses only if, outside of the bankruptcy context, the question of patent license assignability would be governed by state law, as opposed to federal common law. To determine which of these two bodies of law applies, the court would have to decide whether there is any applicable exception to *Erie*'s broad proscription on the use of federal common law. The obvious candidate would be the exception described in *Everex*—the one that allows the use of federal common law when the application of state law would "significantly conflict" with some federal policy. Here, the relevant federal policy is federal innovation policy as embodied in the Patent Act. Its goal is spelled out in Article I, Section 8 of the Constitution: ". . . To promote the Progress of Science and the useful Arts . . . "—i.e., to encourage innovation. Thus, only when the application of state law would significantly frustrate the incentive to innovate can we conclude that state law significantly conflicts with federal patent policy.

Reasonable judges will differ about what constitutes a "significant" conflict with the federally created incentive to innovate. One judge might begin by asking, "By what fraction can state law reduce the expected value of the patent monopoly before it 'significantly' frustrates innovation?" Another judge might feel thatquestions about how innovative effort responds to a particular decrease in the value of the patent monopoly are best left to Congress, not the courts, and that any "significant" diminution of the patent's value significantlyconflicts with federal policy *per se*. But in either case, the judges must commit to some quantitative cutoff. The court need not settle on any particular number. It need not, for example, proclaim that "the conflict with federal policy is 'significant' if the expected value of the patent drops by at least 10% . . . or 15%, or 20%." But even if the cutoff is an impressionistic one, still, a cutoff there must be, because if the expected value of the patent is reduced by a small enough fraction, its diminishment will *not* create a "significant conflict" with federal policy. It will fall short of that threshold, and will not qualify for the *Erie* exception.

To determine whether the use of state law would push the patent's expected value below the relevant cutoff, the court must view the problem only from the perspective of the would-be innovator. As the R&D director (for example) decides how much to invest in a research project, how does she compute the likely value of the patent that will result from that project? Suppose she estimates that the right to 17 years' worth of monopoly profits from the technology is expected to have a present value of $1 million. By what fraction will this expected value be reduced, if the R&D director knows in advance that, should the licensee go bankrupt, the license will become freely assignable, reducing the patent-holder's future revenue stream? This is the factual question the court must grapple with.

To answer it, the court must consider at least two empirically determined quantities. First, there is the quantity we have already discussed: the expected probability of licensee bankruptcy. From the R&D director's point of view, how likely is it that the licensee of any patent developed by the company's scientists will go bankrupt during the life of the patent? To estimate this probability, the court might look for an average rate of licensee bankruptcy across all industries, or (more likely) it might want to use technology-specific bankruptcy rates. Either way, the court would want to draw on expert testimony from economists who study innovation and those who study the insolvency rates of various businesses. Ideally, the court would want its probability of licensee bankruptcy to be weighted by the value of the patent. If, for some reason, licensee bankruptcy occurs mostly in situations where the patented technology is nearly useless, then these bankruptcies should not count for much in the overall average, since they only damage the value of a patent that would not have been worth much anyway.

The second quantity the court must estimate is the expected *amount* by which the patent's value would change in the event of licensee bankruptcy. Even in situations where licensee bankruptcy is relatively likely, if the patent's value drops by an average of only, say, 5% when the licensee is bankrupt, then the expected value of the patent might not decline very much overall. We have not focused on this second empirical question in this article, mainly because the *Everex* opinion did appear to account for it, albeit informally. (The court seemed to feel that the reduction in a patent's value in cases of licensee bankruptcy would be very large.[104])

Of course, the court's estimates of these two quantities—the probability of licensee bankruptcy and the expected decrease in a patent's value in the event of licensee bankruptcy—will be subject to the sorts of uncertainties endemic to all social science. But to ignore these empirical questions entirely—to simply assume that 100% of the nation's licensees wind up in bankruptcy, which is essentially what the *Everex* court did—hardly offers a superior alternative.

As noted in Part I, the empirical approach to estimating these two quantities, which the *Everex* court should have adopted, is not restricted to the patent licensing context. The point can be stated in much more general terms. Whenever the federal government has established an

[104] *Cf.*, *Everex*, 89 F.3d at 679, observing that if licenses could be assigned at will, "any license a patent holder granted—even to the smallest firm in the product market most remote from its own—would be fraught with the danger that the licensee would assign it to the patent holder's most serious competitor, a party whom the patent holder itself might be absolutely unwilling to license. As a practical matter, free assignability of patent licenses might spell the end to paid-up licenses . . . . Few patent holders would be willing to grant a license in return for a one-time lump-sum payment, rather than for per-use royalties, if the license could be assigned to a completely different company which might make far greater use of the patented invention than could the original licensee."

incentive scheme to encourage or discourage some sort of behavior, and the application of state law can blunt the federal reward (or punishment) in a particular subset of cases, the logic of this article might apply. Critically, if the target of the incentive scheme must make the key decision (i.e., the decision the incentive scheme is attempting to influence) without himself knowing whether he will fall into the category in which the incentive will be blunted, then he can base his decision only on probabilities. He must calculate the probability that he will, in the future, fall into the incentive-blunting scenario, multiply it by the average magnitude by which the reward (or punishment) is reduced in the incentive-blunting scenario, and adjust his expected federal incentive by the resulting amount.[105] His *ex-ante* estimation of his chances of winding up in the incentive-blunting situation is a critical empirical calculation—one on which he must take a position, whether implicit or explicit. If a court evaluating the problem does not face up to the necessity of this calculation, it will have no way to determine the *amount* by which the federal incentive scheme is dampened by the use of state law. In particular, it will not be able to tell whether this amount is "significant," and will therefore be unable to figure out whether federal common law should be applied under the *Lear/O'Melveny* exception to *Erie*.

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[105] In fact, it may not be as simple as multiplying two numbers. Most generally, the probability of finding oneself in the incentive-blunting subset will be a function of the whole possible array of future scenarios. Each combination of variables specifying a given future scenario will bring with it a probability of its occurrence, a probability of the decision-maker's falling into the incentive-blunting category should that future occur, and a magnitude by which the incentive would be blunted should the decision-maker fall into that category. Computationally, one would have to integrate over all relevant variables describing all possible future states of affairs. Having thus calculated the *ex-ante* expected magnitude of the incentive, the decision-maker would probably want to correct for the cost of risk-bearing. E.g., a 50% probability of having a federal reward blunted by half does not reduce the reward by precisely 1/4. It does reduce the expected reward by 1/4 (50% of one half), but one also has to correct for the absolute cost of bearing the risk. If the decision-maker is risk-averse, he will prefer an absolute guarantee of a 75% payout to a 50% chance of a full payout plus a 50% chance of a one-half payout, even though the two situations give him the same expected value. This extra cost of risk-bearing must be subtracted from any expected reward (or added to any expected punishment) to get the decision-maker's true *ex-ante* behavioral incentive.

This highly abstract description of the problem is not merely a fancy way of restating the facts of *Everex*. It applies to other fact patterns as well. In particular, as we saw in Section VI.B, the Supreme Court case of *Robertson v. Wegmann* provides a concrete example completely outside the patent context. In that case, the Court was confronted with a federal incentive scheme that sought to discourage the violation of civil rights by state officials, by saddling violators with civil liability. Applying state law would have blunted this federally created incentive (i.e., reduced the severity of the punishment) in those cases where the victim of the civil-rights violation happened to die before trial, leaving no close relatives behind. Whether such an untimely—and lonely—death was going to befall any given victim of a civil-rights violation would almost certainly be unknown to the decision-maker (the state official) at the time she was deciding whether to commit that violation. (Indeed, the Supreme Court specifically noted that its logic might not work if the state official knew, at the moment of decision, that her victim would likely die before trial.[106]) Because the state official would not know whether her particular victim would fall into the loophole created by Louisiana law, she would be forced to play the probabilities. But the probability of the punishment being dampened by the Louisiana survivorship rule was, as an empirical matter, very low: Very few victims of civil-rights violations end up dying before trial with no living spouse, sibling, parent or child. Hence, there

[106] As noted above, the decision-maker must, at the moment of decision, be ignorant of whether his case will fall into the incentive-blunting category. The Supreme Court pointed out, in passing, that the situation might be different if the civil-rights violation itself had caused the plaintiff's death. Robertson v. Wegmann, 436 U.S. 584, 592 (1978). In a footnote on the same page, Justice Marshall again underscores the importance of the fact that the decision-maker must be ignorant of whether he will find himself in the incentive-dampening situation. "In order to find even a marginal influence on [the civil-rights violator's] behavior as a result of Louisiana's survivorship provisions," Marshall wrote, "one would have to make the rather farfetched assumptions that a state official had both the desire and the ability deliberately to select as victims [of civil-rights violations] only those persons who would die before conclusion of the § 1983 suit (for reasons entirely unconnected with the official illegality) and who would not be survived by any close relatives." *Id.* at 592 n.10.

was no “significant” conflict with federal civil-rights policy, and thus no need for federal common law.

Given the generalized statement of the problem above, and the particular examples of both *Everex*, in which the Ninth circuit missed the need for an empirical assessment of probabilities, and *Robertson v. Wegmann*, in which the Supreme Court correctly took account of that need, one could presumably find other examples in the law—examples of federal incentive schemes to which the very same logic would apply. Unearthing such legal problems, and discovering how courts looking at them have treated the probabilistic part of the*Erie* analysis, would make a useful project for future research.