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Why the Ninth Circuit Decided *Everex* as if Every Patent Licensee in America Were Destined for Bankruptcy

Matt Siegel^{†*}

ABSTRACT

A patent licensee that declares bankruptcy will often want to assign its rights under the license to another party in exchange for cash. The Bankruptcy Code generally allows a debtor to assign an executory contract, including a patent license, even if it contains a provision expressly forbidding assignment (a “no-assign” provision). 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. 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 *bars* assignment unless the license says otherwise. As it turns out, the federal common-law rule is the type of non-bankruptcy

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rule the Code will defer to, while the state-law rule is not. Thus, only if federal common law would govern questions of patent license assignability *outside of bankruptcy* will the Code prevent a bankrupt licensee from assigning a license with a no-assign provision.

Under the *Erie* line of cases, whether federal common law applies to patent license assignability questions outside of bankruptcy depends only on 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 the use of state law *would* significantly conflict with federal patent policy, by allowing patent licensees to assign their licenses even in the face of no-assign provisions, thus depriving the licensors/patent-holders of much of the value of the patent monopoly.

But the *Everex* court failed to account for the fact that the use of state law only frustrates no-assign provisions when the licensee *happens to be bankrupt*. Outside of the bankruptcy context, the Bankruptcy Code does not apply, and no-assign provisions in patent licenses are routinely enforced, whether state contract law or federal common law is being applied. Therefore, from the perspective of the would-be innovator (the scientist or R&D director deciding how much effort to put into a new project), the *ex ante* expected value of the patent—and thus the incentive to innovate—may not be significantly reduced by the use of state law. In particular, it will not be significantly reduced if the probability is low that the eventual licensee of the innovator's patented invention will wind up going bankrupt. The *Everex* court ignored the necessity of estimating this probability, and decided the case as if the actual number were 100%. Other courts may be tempted to do the same, when faced with similar facts and also in other, non-patent-related settings.

I. INTRODUCTION

When a technology-intensive company declares bankruptcy, some of the bankruptcy estate's most valuable resources are likely to be the company's patent licenses.¹ A

¹ 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 ("[A] patent license may be among a debtor's most valuable assets."). A

bankrupt licensee will often want to capitalize on its patent licenses by assigning its rights under those contracts to the highest bidder in exchange for payment. This can enable the bankrupt company to better reimburse its creditors in a liquidation scenario, or facilitate the company's reorganization under Chapter 11 of the Bankruptcy Code (the Code).²

Perhaps 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 been confronted with cases of the sort that raise the special legal problems associated with patent licenses.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 legal tool for the rehabilitation and restructuring of high-technology companies."⁴ The treatment of patent licenses in bankruptcy has also attracted a fair amount of scholarly attention, both because of its practical importance in a technology-intensive economy and because authors still have serious doubts about exactly when a bankrupt licensee should be allowed to assign its rights under a patent license to a third party.⁵

patent license allows the company, as licensee, to use a proprietary technology at some previously agreed royalty rate, and if the contractually determined royalty payments are less than the expected profit one could earn by using the patented technology, the license can be a source of significant value.

² 11 U.S.C. §§ 101-1330 (2000).

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, 593 (2001) (noting that "[t]he financial debris of the excess exuberance has now fallen into the bankruptcy courts . . .").

⁴ *Id.*

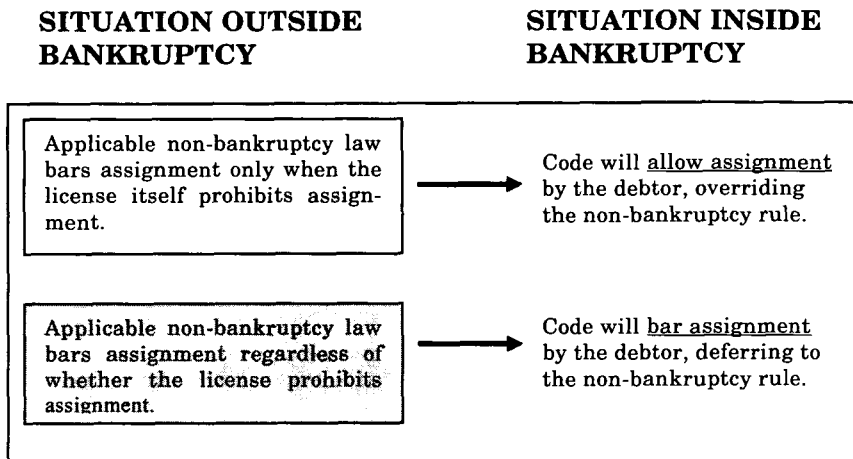
⁵ See, e.g., Brett W. King, *Assuming and Assigning Executory Contracts: A History of Indeterminate "Applicable Law,"* 70 AM. BANKR. L.J. 95 (1996) (discussing a drafting paradox in the Code caused by the fact that § 365(f) explicitly permits a trustee or debtor-in-possession to assign even if it would override "applicable law," while § 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 and concluding that (i) the post-*Erie* trend of applying federal common law to the issue has been implemented somewhat blindly and will likely be reconsidered by courts, and (ii) the sensible approach is to do away with the blanket rule and establish a new approach under which patent licenses are presumed assignable only when assigning them would have no material adverse impact on the licensor); Aleta A. Mills, Comment, *The Impact of Bankruptcy on Patent and Copyright Licenses*, 17 BANKR. DEV. J. 575 (2001) (recommending special legislation permitting 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 1 (discussing patent license assignment in bankruptcy as part of a practitioner's survey of issues at the

One Code provision suggests that a bankrupt licensee generally can assign its rights under a patent license. Indeed, that part of the Code provides that the licensee can assign its rights *even if the license itself contains language explicitly prohibiting assignment*. (In this discussion, we will refer to such explicit anti-assignment language in a patent license as a “no-assign provision.”) Another part of the Code, however, creates an exception to this strong pro-assignability rule. Under the exception, the Code will defer to certain kinds of non-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, then, the Code does not give a simple answer.

It is important to note that the Code will not defer to *all* non-bankruptcy law that would ordinarily bar assignment, but only to certain kinds of non-bankruptcy law. 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 provision*. This last phrase defines the subset of non-bankruptcy law that the Code will defer to, as shown in Chart 1 below.

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 an economic efficiency analysis to the policy underlying the “applicable law” exception in § 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 such questions violates the *Erie* doctrine, because no specific federal policy or interest dictates that the patentee should be shielded from an 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). 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) (asserting that the *Erie* doctrine requires that state merger law trump the federal common-law presumption against patent license assignment in the context of “assignment” of a patent license through a corporate merger of the licensee into another company).

Chart 1: The Code's Treatment of the Assignability of a Patent License with a Clear No-Assign Provision



Thus, the problem of whether a bankrupt licensee can assign a patent license containing a no-assign provision reduces, in large part, 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 that the Code will defer to (i.e., 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, then the Code's general preference for assignability will prevail, and the bankrupt licensee will be allowed to assign.

When considering which body of non-bankruptcy law should govern patent license assignability outside of bankruptcy, one finds that there are only two candidates: state contract law, and a rule of federal common law developed in the 1850s that specifically applies to patent licenses. In general, state contract law will permit the assignment of a contract—including a patent license—unless the contract explicitly states otherwise.⁶ The federal common-law rule, by

⁶ This is a fair simplification for the purposes of this Introduction. The content of state law regarding contract assignability is discussed in more detail at note 34, *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 Systems, Inc. v. Cadtrak Corp. (In re CFLC, Inc.)*, 89 F.3d 673 (9th Cir. 1996)—the case whose analysis is the subject of this paper—assumed that California state law (which is fairly typical on this point) would have permitted

contrast, shifts the presumption in favor of non-assignability: It 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 how a given body of non-bankruptcy law treats such "silent" licenses is precisely what determines whether the Code will defer to that body of law. To see this, consider the distinction between the two bodies of law, as illustrated by Chart 2.

Chart 2: The Difference Between State Law and Federal Common Law on Patent License Assignability, Outside of the Bankruptcy Context

	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

As Chart 2 illustrates, outside of bankruptcy, the two bodies of law differ only in the middle column, where the license is silent on assignability. Chart 2 also shows that, as a result of this difference, only the federal common-law rule bars assignment *whether the license contains a no-assign provision or not*. But this is precisely the precondition required outside of bankruptcy in order for the Code to bar assignment by a licensee that is in bankruptcy.⁷ Thus, if state contract law applies to questions of patent license assignability outside of bankruptcy, then inside bankruptcy the Code will override that law, and bankrupt licensees will be allowed to assign, even in the face of a clear no-assign provision. On the other hand, if

assignment of the license in question had it not contained a no-assign provision. Therefore, it makes sense 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.

⁷ See *supra* Chart 1.

federal common law governs patent license assignability questions outside of bankruptcy, 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 provision. (Indeed, they will not be allowed to assign even if the license is silent on the issue.) In short, the fate of the debtor-licensee who is saddled with a no-assign provision depends entirely on which of these two bodies of law applies to patent license assignability questions outside of bankruptcy.

To determine which body of law does apply outside of bankruptcy, one must use the analysis found in the line of cases following *Erie Railroad v. Tompkins*.⁸ These cases, which are a mainstay of any federal courts class in law school, describe the 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 fall into some specific exception to *Erie*'s broad proscription of federal common law. If an *Erie* exception does apply, federal common law will govern.

This Article will argue that there is just one circuit-court case, *Everex Systems, Inc. v. Cadtrak Corp. (In re CFLC, Inc.)*,⁹ that has ever seriously attempted to use the *Erie* doctrine to decide which body of law governs questions of patent license assignability. As the *Everex* court concluded, the *Erie* line of cases would allow the use of federal common law to decide these questions only if using state contract law to decide them would significantly conflict with some federal policy. The *Everex* court went on to find that using the state-law rule would indeed significantly conflict with a federal policy, namely federal patent policy, because "[a]llowing free assignability—or, more accurately, allowing states to allow free assignability—of nonexclusive patent licenses would undermine the reward that encourages invention"¹⁰ From the *Everex* court's perspective, if state contract law were to govern patent license assignability issues outside of bankruptcy, then whenever a licensee became bankrupt, the Code would allow the licensee to assign, even if its license contained a no-assign provision. For reasons explained in Part II below, overriding a no-assign

⁸ 304 U.S. 64 (1938).

⁹ 89 F.3d 673 (9th Cir. 1996).

¹⁰ *Id.* at 679.

provision in this way will often render a patent license far less valuable to the licensor, thus seriously diminishing 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 significantly undermine the federally created incentive to innovate.

This conclusion has not been immune to scholarly critique. The most fundamental attack on *Everex*, offered by Carole A. Quinn and R. Scott Weide, asserts that Congress's persistent failure to amend the Patent Act to include even so much as a reference to patent licenses should be regarded as a tacit acknowledgment that there is no federal policy of protecting the value of the patent monopoly against ordinary variations in state contract law.¹¹ According to Quinn and Weide, this is especially so considering the numerous court battles that have been fought to determine which body of law governs the assignability of patent licenses.¹² Such court cases, in Quinn and Weide's view, should have put Congress on notice that this was a contested issue. However, as Part V shows, this critique relies heavily on its authors' tenuous assumptions about the meaning of Congressional silence.

It turns out, however, that arguments such as Quinn and Weide's are not necessary to discredit the *Everex* decision, because *Everex* contains a serious logical error even on its own terms—that is, even if one assumes that there is a federal policy of protecting the value of the patent monopoly against the normal operation of state contract law. Here is why. The *Everex* court found that using state contract law to decide questions of patent license assignability would significantly undermine federal patent policy by substantially diminishing the economic value of the patent. If state law were to govern questions of patent license assignability, according to the *Everex* court, then bankrupt licensees could always violate the no-assign provisions 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

¹¹ See, e.g., Quinn & Weide, *supra* note 5, at 1142-43 (noting that Congress did not draft § 261 of the Patent Act to clarify the rights of a licensee and did not include such clarification in two subsequent amendments of that section, to support the idea that there may not be a federal policy to "always protect" exclusive government-granted patent rights).

¹² See *id.* ("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.").

world—namely, that *most licensees do not end up in bankruptcy*.

The *Everex* court reasoned that if state law governed questions of patent license assignability, “every licensee” would suddenly be permitted to disregard the no-assign provision in its patent license, depriving the licensor of his monopoly profits.¹³ 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 provisions in the least, because both state and federal common law lead to the same result: If a license contains a no-assign provision, 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 provision. 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 monopoly. But that is not the perspective federal patent policy cares about. Federal patent policy, by definition, is concerned only with the perspective of the would-be innovator, e.g., 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.

Thus, if a court wishes to opine on whether the use of state law to decide questions of patent license assignability “significantly” reduces the patent’s value from the *ex ante* perspective, the 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

¹³ See *Everex*, 89 F.3d at 679 (remarking that, if states are permitted to allow free assignability of patent licenses, “every licensee would become a potential competitor” of the licensor in the market for rights to make, sell, or use the technology).

position on the probability of licensee bankruptcy. Indeed, it never even mentioned that such a determination might be relevant. And *Everex*'s scholarly critics have likewise ignored this 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 seems to have been ignored by both the *Everex* court and its critics.

Part II of this Article explains the compelling economic reasons why patent licensors often include no-assign provisions in their licenses. Part III discusses § 365(f) of the Bankruptcy Code, which 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 provision. It then introduces § 365(c)(1) of the Code, which 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 shows 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, notwithstanding a no-assign provision, 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 in spite of a no-assign provision 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*: a criticism of the *Everex* court's failure to take a position on the probability of licensee bankruptcy. The need for such an empirical analysis, which the *Everex* court overlooked, is not an entirely new idea. In fact, the Supreme Court made this same point, in a completely different context, in *Robertson v.*

Wegmann,¹⁴ also discussed in Part VI. Part VII then anticipates, and rejects, a few reasons why one might doubt this Article's main criticism of *Everex*. Finally, Part VIII sketches out the analysis that the *Everex* court should have used and that future courts might employ when confronted with similar questions. It also observes that this Article's basic argument can apply to many *Erie* analyses unrelated to patents or patent licenses. Specifically, the same argument can apply whenever a court is trying to decide whether the application of state law "significantly conflicts" with a federal policy, and the facts before the court belong to some special subset of cases in which state law does impair the federal policy. A court in this situation will often be tempted to analyze the "significant conflict" standard only over this special subset of cases, as the *Everex* court did. Instead, the court should always ask whether the application of state law significantly conflicts with the relevant federal policy *overall*, measuring the federal policy over the entire range of circumstances to which it applies, not just over the special subset. Focusing narrowly on fact patterns in which state law injures federal policy, and forgetting about the many situations where it does not, can lead to an improper proliferation of federal common law. In conclusion, Part VIII summarizes some of the reasons why we may want to resist the temptation to create "too much" federal common law.

II. THE ECONOMIC IMPORTANCE OF PATENT LICENSE ASSIGNABILITY

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 companies (and people) are good at discovering new technologies, while others excel at applying those technologies in the marketplace. Rather than forcing every patentee to sell the fruits of her own research, the law allows innovators to license their proprietary technologies to the companies that will best employ them.

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 last possibility—contractual silence—raises interesting questions, but it will not be our

¹⁴ 436 U.S. 584 (1978).

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 issue of assignability.¹⁵ We are left, then, with those licenses that are explicitly assignable, and those that contain a no-assign provision. 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 § 365(c)(1) never arise. But in fact, companies that license their patented technologies often have good reasons to prefer that the licenses not be assignable, and therefore most valuable patent licenses contain no-assign provisions.¹⁶

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 insure that the technology cannot be assigned so that it can protect its 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. The resulting competition between the two would enable the would-be licensee to negotiate a lower royalty rate than would have been possible had he been negotiating with the licensor alone.¹⁷ Second, whether or not the license is exclusive, the licensor

¹⁵ Part VII.B briefly considers how this paper's analysis might be extended to include licenses that are silent on the question of assignability.

¹⁶ In fact, such provisions often say that the license can be assigned, but only with the consent of the licensor. Since we are concerned here with situations in which the assignment robs the licensor of value—and where the licensor would therefore not typically agree to an assignment—the possibility of such mutually agreeable assignment does not change anything in our analysis.

Note also that even if a license does contain a no-assign provision, if its value to some third-party firm is sufficiently high, the licensee can try to "assign" the license to that firm by merging with the firm or being taken over by it. For an example of this, see *PPG Indus. v. Guardian Indus.*, 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.

¹⁷ See, e.g., *Everex Sys., Inc. v. Cadtrak Corp. (In re CFLC, Inc.)*, 89 F.3d 673, 679 (9th Cir. 1996). The court observed that if one allows a non-exclusive patent license to be assignable:

[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[].

Id. at 679. (emphasis in original).

may insist on a no-assign provision 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, which cannot possibly use the technology to compete in the licensor's home market. Without a no-assign provision, the licensee could turn around and assign the license to the licensor's main competitor, destroying the licensor's competitive advantage.¹⁸

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. For example, suppose 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 go bankrupt, thereby gaining the right to assign the license. It would be as if the licensor were forced to sell the licensee a kind of "bankruptcy insurance," by awarding the licensee the valuable right to assign its license only in those instances where the licensee has declared bankruptcy. If the two parties think the chance of an eventual bankruptcy is high, then the licensor will insist on 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.¹⁹ The point is this: The expected probability of licensee bankruptcy will affect the royalty rates paid by all licensees, even those who never end up in bankruptcy—just as,

¹⁸ This is what occurred in *Unarco Indus., Inc. v. Kelley Co.*, 465 F.2d 1303 (7th Cir. 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.").

¹⁹ I thank John DiPaolo for pointing out that the insurance metaphor was better than the "lottery" metaphor.

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

III. THE DIFFERING EFFECTS OF APPLYING STATE CONTRACT LAW AND FEDERAL COMMON LAW OUTSIDE OF THE BANKRUPTCY CONTEXT

The statutory analysis of whether patent licenses are assignable by a bankrupt licensee begins with §§ 365(a) and 365(f) 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 provisions.²⁰ Specifically, § 365(a) says that the trustee or debtor-in-possession²¹ "may assume or reject any executory contract . . . of the debtor."²² When a contract is assumed under § 365(a), the debtor and any other parties to the contract continue to be bound by it just as if no bankruptcy had occurred.²³ Section 365(f) provides as follows: "Except as provided in . . . [§ 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

²⁰ Section 365 of the Code never mentions patent licenses by name. It speaks of "[e]xecutory contracts and unexpired leases" held by the debtor. 11 U.S.C. § 365 (2004). But the term "executory contract" has routinely been construed to include non-exclusive patent licenses. *See, e.g., Everex*, 89 F.3d at 677 (holding that a patent license was an "executory contract"—i.e., one in which substantial performance remained due on both sides—because the licensor owed "significant continuing performance" to licensee, in that the licensor "must continue to refrain from suing [the licensee] for infringement . . ."). *See generally* Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973) (giving the classic definition of "executory contract").

There is considerable doubt about whether an *exclusive* license would be regarded as an executory contract for the purposes of § 365. Particularly, if such a license prevented the licensor from using the technology in question, a bankruptcy court might find that it more closely resembled an outright transfer of the patent than an executory contract. Kuney, *supra* note 3, at 598. In that case, the patent would simply be treated as property of the debtor, and § 365 would not apply. Accordingly, the present discussion can be applied reliably only to non-exclusive patent licenses.

²¹ For the sake of simplicity, this Article will refer to the "debtor" as the one who assumes or assigns a contract, even though it is technically the trustee or debtor-in-possession that does so.

²² 11 U.S.C. § 365(a) (2000).

²³ 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), (b)(1)(A) (2000).

assignment of such contract . . . , the [debtor] may assign [a contract it has assumed under § 365(a)] . . . ,”²⁴ so long as the debtor gives the court “adequate assurance” that the assignee will perform.²⁵

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, but 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.²⁶ In any case, it does amount to a transfer of wealth from one contract party to another, triggered by the latter’s bankruptcy.²⁷

As we saw in Part I, the Code contains an important exception to this rule of ignoring no-assign provisions in contracts. Section 365(c)(1) says that if some otherwise applicable body of non-bankruptcy law would have barred assignment of a contract outside of bankruptcy—and would have barred such assignment *regardless of whether the contract contained a no-assign provision*—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 provision or not, just as the non-bankruptcy law would have done.²⁸ (See Chart 1

²⁴ 11 U.S.C. § 365(f)(1) (2000). *See also* 11 U.S.C. § 365(f)(2)(A) (2000) (providing that a trustee may assign executory contract only if he assumes it in accordance with § 365).

²⁵ 11 U.S.C. § 365(f)(2)(B) (2000).

²⁶ *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) (asserting 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).

²⁷ Essentially, because of this rule, every contract that contains a no-assign provision implicitly contains a “bankruptcy insurance” policy of the sort discussed in Part II.

²⁸ Section 365(f), which invalidates no-assign provisions, specifically recognizes § 365(c) as an exception. Section 365(c) reads as follows:

§ 365. Executory contracts and unexpired leases

...

above for an illustration of the type of non-bankruptcy law to which the Code will defer.)

The idea behind § 365(c)(1) is subtle, but sensible. If the applicable non-bankruptcy law would ordinarily bar assignment only when the contract contained a no-assign provision, 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 routinely enforces no-assign provisions, as an applicable body of non-bankruptcy law that would ordinarily bar assignment. The Code would then 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 provisions.²⁹ On the other hand, if the applicable body of non-bankruptcy law would bar assignment *regardless* of whether the contract contained a no-assign provision, then whoever wrote that law (Congress, the state legislature, etc.) must have

(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 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) (2000).

Note the repetition of the clause “whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties.” 11 U.S.C. § 365(c), (c)(1)(A) (2000). The second appearance of this clause, in section 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., whether or not the contract contains a no-assign provision.

Section 365 is a confusingly drafted provision, and the discussion of it here has intentionally ignored certain unsettled debates about its meaning, which would take us far from the topic of this Article and are not essential to it. 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 debtor would be prohibited from assigning an executory contract under this provision, it 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 26; Reilly, *supra* note 5. See also *Ford Motor Co. v. Claremont Acquisition Corp.* (In re *Claremont Acquisition Corp.*), 186 B.R. 977, 980-84 (C.D. Cal. 1995), for a detailed discussion of point (ii) above.

²⁹ See Reilly, *supra* note 5, at 22 (noting that the second “whether or not” clause in § 365(c) excludes from “applicable law” rules of contract interpretation that disallow assignment simply because the parties chose to disallow assignment).

done so for overarching policy reasons, beyond the mere desire to enforce private agreements. This is the sort of non-bankruptcy law to which the Code will defer. Thus, the Code defers to "policy-based" non-bankruptcy rules that bar assignment, but not to rules that bar assignment just to enforce privately negotiated no-assign provisions.

Once one understands this aspect of § 365(c), it becomes clear that the central practical question of this Article—whether a no-assign provision will be enforced, or ignored, in bankruptcy—can be answered only by looking at the body of law that would ordinarily apply to questions of patent license assignability outside of the bankruptcy context. In fact, there are only two candidates. First there is state contract law, which governs questions of contract assignability generally, along with almost all aspects of patent license construction other than assignability questions.³⁰ Second, as noted 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.³¹

For the moment, let us put aside the question of which of these two bodies of law actually applies to questions of patent license assignability outside of bankruptcy. The answer is unclear. Instead, we will do a brief thought experiment, and

³⁰ See *Lear, Inc. v. Adkins*, 395 U.S. 653, 661-62 (1969) (finding that 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, was "solely a matter of state law . . ."); *Lockett v. Delpark, Inc.*, 270 U.S. 496 (1926) (noting that, in general, a suit by a patentee for any remedy in respect of the contract permitting use of the patent is not a suit under the U.S. patent laws); *Everex Sys., Inc. v. Cadtrak Corp. (In re CFLC, Inc.)*, 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. Mitsubishi Cutlery, Inc.*, 67 F.3d 917, 920 (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)); 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.").

³¹ See *Everex*, 89 F.3d at 679 (describing the recent history of the federal rule). See also *Troy Iron & Nail Factory v. Corning*, 55 U.S. 193, 216 (1852) (setting forth the rule 153 years ago); *Bowers v. Lake Superior Contracting & Dredging Co.*, 149 F. 983, 986 (8th Cir. 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 ("Courts have developed a federal common law default rule that governs the transferability of patent license rights.").

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:

Chart 2 (Again): The Difference Between State Law and Federal Common Law on Patent License Assignability, Outside of the Bankruptcy Context

	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

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 provision? Initially the judge will look to the Code, where she will find § 365(f), setting forth the general rule that the debtor may assign the license, regardless of the no-assign provision. But the judge will also have to consider § 365(c)(1), which carves out an exception to the pro-assignability rule of § 365(f). As discussed above,³² this exception applies only where the applicable non-bankruptcy law would ordinarily bar assignment regardless of whether the license contained a no-assign provision. Here, by assumption, the "applicable law" is state contract law, and in most states, contract law principles would bar assignment if the license contained a no-assign provision but would permit assignment if it did not.³³ In other words, state law construes contractual silence in favor of assignability.³⁴ Thus, it cannot be said that

³² See *supra* Chart 1 and accompanying text.

³³ See *supra* Chart 2.

³⁴ The *Everex* court presumed that, outside of bankruptcy, state contract law would allow assignment of a patent license that did not contain a no-assign provision. In fact, as David Kuney has suggested, 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. See *infra* notes 62-66 and accompanying text. It is difficult to say how state

the applicable non-bankruptcy law bars assignment regardless of whether the license contains a no-assign provision because, in fact, state law gives different results depending on whether the license contains a no-assign provision, as illustrated in Chart 2. Therefore, the condition of § 365(c)(1) is not met. Section 365(f) controls, and the Code will allow the debtor to assign.³⁵

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 the rule that patent licenses, unlike most other contracts, should be presumed to be *non-assignable* absent some explicit contractual language to the contrary.³⁶ Thus, in the federal common law world, if a bankruptcy court were faced with a patent license containing a no-assign provision, it would 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 provision. In other words, outside of bankruptcy,

courts would treat the issue of patent license assignability under state contract law in any given case, largely because patent license assignability has typically been controlled by federal common law (due in large part to opinions like *Everex*, which this Article argues may have been wrongly decided). In any event, one state supreme court did reach this issue under state law, and concluded that the license in question should be presumed assignable. *Farmland Irrigation Co. v. Dopplmaier*, 308 P.2d 732, 740-41 (Cal. 1957). For the purposes of this Article, we assume only that the *Dopplmaier* decision was not aberrant. That is, we assume that a significant number of patent licenses (if not all of them) would be presumed assignable under state contract law, absent any contractual language to the contrary. The *Everex* decision would certainly apply to those licenses; so the argument of this Article would be relevant to them as well.

The Restatement (Second) of Contracts 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 . . ." RESTATEMENT (SECOND) OF CONTRACTS §317(2) (1979). As Marie T. Reilly points out, this language begs the question of what happens under state law when the assignment of a license to a second licensee would result in the very same stream of royalties to the licensor, but would deprive the licensor of the *even larger* royalty stream it could have gotten by issuing a new license to the second licensee, with no competition from the first licensee. 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.).

³⁵ See Reilly, *supra* note 5, at 18-22 (noting that whether the Code will defer to a non-bankruptcy bar on assignability depends entirely on what the non-bankruptcy rule would do if the contract were (hypothetically) silent on the question of assignability).

³⁶ See *Troy Iron & Nail*, 55 U.S. at 216; see generally *supra* note 31.

one could have scratched out the no-assign language and it wouldn't have made any difference, since the federal rule would have barred assignment in both the right-most and center columns of Chart 2. Therefore, the condition of § 365(c)(1) is met. The Code will defer to the federal rule that applies outside of bankruptcy, and the bankrupt licensee will not be allowed to assign.

Our thought experiment is now complete, and the conclusion is clear. If state common law applies to questions of patent license assignability outside of bankruptcy, then a bankrupt licensee may assign its license, notwithstanding a no-assign provision. But if federal common law governs those questions, a bankrupt licensee may not assign, whether the contract contains a no-assign provision or not. Therefore, whether a bankrupt licensee may 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 them?

IV. THE CHOICE-OF-LAW QUESTION

A. *The Erie Doctrine*

The federal common-law rule for questions of patent license assignability was created by the Supreme Court in the 1852 case of *Troy Iron & Nail Factory v. Corning*.³⁷ 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.³⁸ But the scope of federal common law in general was dramatically narrowed in 1938 by the U.S. Supreme Court's landmark decision in *Erie Railroad v. Tompkins*.³⁹ On its face, *Erie* forbade the creation of federal common law (i.e., judge-made law), except when the federal courts were interpreting federal statutes or the Constitution.⁴⁰ Beyond that, creating federal common law exceeded the constitutional powers of the federal

³⁷ 55 U.S. 193 (1852).

³⁸ See, e.g., *id.* at 216; *Oliver v. Rumford Chem. Works*, 109 U.S. 75, 83 (1883); *Hapgood v. Hewitt*, 119 U.S. 226, 234 (1886); *Lane & Bodley Co. v. Locke*, 150 U.S. 193, 195-96 (1893); *Bowers v. Lake Superior Contracting & Dredging Co.*, 149 F. 983, 986 (8th Cir. 1906).

³⁹ 304 U.S. 64 (1938).

⁴⁰ *Id.* at 78.

courts.⁴¹ Thus, federal common-law rules of contract interpretation, such as the rule pertaining to patent license assignability, should have been nullified by *Erie*.

However, the Supreme Court has re-expanded the scope of federal common law considerably by carving out a number of exceptions to *Erie*, and today the exact boundaries of the federal courts' power to create common law are somewhat unclear.⁴² 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 courts decided that the federal common-law rule did still apply. But these four cases hardly represent an overpowering tide of opinion. The California State Supreme Court has come down on the other side, holding that in the post-*Erie* period, questions of patent license assignability should be governed by state law, not federal common law.⁴³ And of the four federal circuit decisions on the topic, only two—*Unarco Industries v. Kelley*⁴⁴ and *Everex Systems Inc. v. Cadtrak Corp.*⁴⁵—even attempted to do an *Erie*-style analysis of the proper scope of federal common law. The other two opinions, *Rock-Ola v. Filben*⁴⁶ and *PPG Industries v. Guardian Industries*,⁴⁷ embraced the federal common-law rule only in dicta and supported their conclusions by simply citing prior federal cases, without independently analyzing whether it was proper to apply the federal common-law rule in the wake of *Erie*. Moreover, the only U.S. Supreme Court decisions cited in these two opinions were decided prior to *Erie*, and so could hardly be expected to embody the post-*Erie* standard. Let us examine in turn the two more substantial post-*Erie* decisions: *Unarco* and *Everex*.

⁴¹ *Id.*

⁴² See generally 19 CHARLES ALAN WRIGHT, ET AL., FEDERAL PRACTICE & PROCEDURE § 4514, nn.5-38 and accompanying text (2d ed. 1996 & Supp. 2003) (describing existence of myriad post-*Erie* instances of federal common law).

⁴³ *Farmland Irrigation Co. v. Dopplmaier*, 308 P.2d 732, 739 (Cal. 1957). Three of the four post-*Erie* federal circuit court cases were decided after *Dopplmaier*, and it may be that the California Supreme Court, if confronted with the issue today, would find those three decisions persuasive. Still, the *Dopplmaier* decision does remain good law in California, and the fact that its outcome differed from that of the federal circuit courts at least gives us reason to believe that the issue is a disputed one.

⁴⁴ 465 F.2d 1303, 1305 (7th Cir. 1972).

⁴⁵ 89 F.3d 673, 678 (9th Cir. 1996).

⁴⁶ 168 F.2d 919, 922 (8th Cir. 1948).

⁴⁷ 597 F.2d 1090, 1093 (6th Cir. 1979).

B. Unarco

The *Unarco* court supported its decision to embrace federal common law by citing *Sola Electric Co. v. Jefferson Co.*, a Supreme Court case decided four years after *Erie*, in which the Court carved out an exception to *Erie*'s rejection of federal common law.⁴⁸ The *Unarco* court relied on the following (rather cumbersome) passage from *Sola*:

[The *Erie* doctrine is] "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."⁴⁹

The *Unarco* court found that questions of patent license assignability did fall into this exception to *Erie*, and must therefore be controlled by federal common law.⁵⁰ 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 question with respect thereto must be governed by federal law.⁵¹

Therefore, the *Unarco* court concluded, "the question of assignability of a patent license is a specific policy of federal patent law dealing with federal patent law."⁵²

But *Unarco*'s invocation of *Sola* was misplaced. Based on the cumbersome passage quoted two paragraphs above, the *Sola* Court clearly permitted 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 had to be controlled by federal law.⁵³

⁴⁸ See *Sola Elec. Co. v. Jefferson Co.*, 317 U.S. 173, 176 (1942); *Erie*, 304 U.S. 64, 78 (1938).

⁴⁹ *Unarco*, 465 F.2d at 1306 (quoting *Sola*, 317 U.S. at 176).

⁵⁰ *Unarco*, 465 F.2d at 1306.

⁵¹ *Id.*

⁵² *Id.*

⁵³ *Sola*, 317 U.S. at 176.

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 considered “dominated by the sweep of federal statutes”⁵⁴—namely, the Patent Act. But if that is a basis for allowing the creation of federal common law under *Sola*, then federal common law must apply to all “legal relations” affected by the Patent Act, for that is what the cumbersome quotation from *Sola* says. This means that federal law would have to eclipse state contract law on every conceivable issue of patent license construction, not just issues of assignability. But in fact, courts routinely treat almost every aspect of patent license construction other than assignability as a matter of state, not federal, law.⁵⁵ As the *Everex* court noted twenty-four years after *Unarco*, *Unarco*’s conclusion that *Sola* requires “any question with respect” to “the licensing of patents” to be governed 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.”⁵⁶

C. Everex

Because the *Unarco* decision contains this fundamental flaw, the *Everex* case currently stands as the one circuit court decision in which the court undertook a meaningful *Erie* analysis of the patent license assignability issue. 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.

In the events leading up to *Everex*, a licensee had declared bankruptcy, and the bankruptcy trustee wanted to assign the license to a third party, even though the license

⁵⁴ *Id.*

⁵⁵ As Quinn and Weide have noted:

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.

Quinn & Weide, *supra* note 5, at 1143-44. See also sources cited *supra* note 30.

⁵⁶ *Everex Sys., Inc. v. Cadtrak Corp. (In re CFLC, Inc.)*, 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.”).

explicitly prohibited assignment.⁵⁷ 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: whether, outside of bankruptcy, issues of patent license assignability are governed by federal common law.⁵⁸ The *Everex* court's effort to answer that question is well summarized in a single paragraph from its opinion:

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 the invention for a period of years." 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.⁵⁹

"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 [contract law], that would allow assignability.*"⁶⁰ 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 § 365(c)(1) of the Code, which defers to the federal common-law rule, as we saw in Part III.⁶¹

⁵⁷ *Everex*, 89 F.3d at 674-75. The license at issue was non-exclusive, so it was treated as an executory contract under the Code. See *supra* note 20.

⁵⁸ *Id.* at 677.

⁵⁹ *Id.* at 679 (citations omitted).

⁶⁰ *Id.* (emphasis added).

⁶¹ *Id.* at 680.

V. WHAT THE PRESENT ARGUMENT ADDS TO THE EXISTING CRITIQUES OF *EVEREX*

The considerable scholarship on the treatment of patent licenses in bankruptcy has included at least two salient critiques of *Everex*, one articulated by David Kuney, the other by Carole Quinn and R. Scott Weide.

A. *David Kuney's Critique*

In a 2001 article, Kuney argues that the *Everex* court may have simply gotten the state-law rule wrong as applied to the patent license under consideration.⁶² If California contract principles would ordinarily have regarded the relevant patent license as being non-assignable even without the no-assign provision,⁶³ Kuney notes, then perhaps California law and federal common law completely coincided in their treatment of that license—which would mean the *Everex* court was creating an *Erie* issue where none existed. As Kuney explains, for a contract that is silent on assignability, “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,”⁶⁴ refusing to allow assignment if it was. Indeed, California contract law does generally prohibit the assignment of contract rights when such assignment would “materially impair the non-assigning party’s chance of obtaining the performance he expected.”⁶⁵ This can be seen as an exception to the usual rule of reading contractual silence to favor assignability.⁶⁶

⁶² Kuney, *supra* note 3, at 627-28.

⁶³ Recall, to pass the § 365(c)(1) test, the applicable law must bar assignment with or without the no-assign provision. See Chart 1, *supra*.

⁶⁴ Kuney, *supra* note 3, at 628.

⁶⁵ See, e.g., *Farmland Irrigation Co. v. Dopplmaier*, 308 P.2d 732, 740-41 (Cal. 1957).

⁶⁶ In their 1999 article, Quinn and Weide made a similar point to 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. 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.”).

It is certainly true that the *Everex* court did not sufficiently defend its conclusion that California state law would ordinarily presume the debtor's license to be assignable under the facts of the case. The district court below believed the license would be presumed assignable under California law, and the Ninth Circuit seems to have accepted this view with little additional analysis.⁶⁷ But the district court based its conclusion on an overly broad reading of the California Supreme Court's *Dopplmaier* decision: the court interpreted *Dopplmaier* to say that "under California law, patent licenses could be freely assigned,"⁶⁸ which clearly went beyond the holding of that case.⁶⁹

Undoubtedly, the reason that neither the Ninth Circuit nor the district court in *Everex* considered the issue very carefully is that both courts ended up holding that, assuming state law did favor assignability, the federal common-law rule would trump state law and the bankrupt licensee could not assign.⁷⁰ Thus, because the fine points of California state law were not outcome-determinative, the district court and Ninth Circuit did not focus on them.

But quarreling with the application of California state contract law to the particular license at issue in *Everex* does nothing to assail *Everex*'s main result: In cases where state law and federal common law differ on how a patent license should be treated, federal law wins, even in a post-*Erie* world. At the very least, we know there are some circumstances in which state-law doctrines like California's would presume a patent license to be assignable. After all, in *Dopplmaier* the California Supreme Court applied California law to a patent license that was silent on the question of assignability and concluded that under the circumstances it could be assigned.⁷¹ If the *Everex* analysis were correct aside from misconstruing California law as applied to the particular license at issue in that case, then

⁶⁷ See *Everex*, 89 F.3d 673 at 679 (speaking of "state laws, such as California's, that would allow assignability").

⁶⁸ In re CFLC, Inc., 174 B.R. 119, 121 (N.D. Cal. 1994).

⁶⁹ In fact, *Dopplmaier* did not conclude that patent licenses are always presumed assignable absent a no-assign provision. Rather, *Dopplmaier* applied the usual California standard described *supra* note 65 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*, 308 P.2d at 740-41.

⁷⁰ See In re CFLC, Inc., 174 B.R. at 124 ("The bankruptcy court properly applied a longstanding rule of federal law.").

⁷¹ *Dopplmaier*, 308 P.2d at 741.

the first time a *Dopplmaier*-like patent license did find its way into bankruptcy court (i.e., a license for which state law followed the pattern shown in the “state-law” row of Chart 2), the bankruptcy court would run the *Everex* analysis all over again, and would reach the same conclusion—and this time it would be immune from Kuney’s critique. In other words, because Kuney’s critique of *Everex* is limited to the particulars of how the court applied California state law to the specific license at issue, it does little to undermine the future influence of the *Everex* court’s reasoning.

B. *Quinn and Weide’s Critique*

In their 1999 article, Quinn and Weide articulated a different critique of *Everex*.⁷² They pointed out that in 1952, when the Patent Act was voted into law,⁷³ Congress must have been aware of the various court decisions concerning patent license assignability, yet it chose not to directly mention patent licenses anywhere in the Act.⁷⁴ Indeed, even after 1957, when the California Supreme Court in *Dopplmaier* held that state contract law governs issues of patent license assignability,⁷⁵ Congress failed to revise the Patent Act to overrule *Dopplmaier*. Quinn and Weide interpret this persistent inaction by Congress as evidence that there is no *Everex*-style “federal policy” urging the protection of the patent monopoly in all cases.⁷⁶ If there were, Quinn and 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 applied to

⁷² See Quinn & Weide, *supra* note 5.

⁷³ 35 U.S.C. §§ 1-376 (2004).

⁷⁴ See Quinn & Weide, *supra* note 5, at 1142-43 (“[W]hile 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 and Weide mean that Congress did not “amend” the various pre-enactment drafts to clarify this issue.

⁷⁵ *Dopplmaier*, 308 P.2d at 739.

⁷⁶ 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 to support this).

patent license assignments.⁷⁷ And if there was any doubt about whether the federal rule had survived *Erie*, the 1952 Congress could have looked to the post-*Erie* Eighth Circuit decision in *Rock-Ola v. Filben* (1948), which had re-asserted the federal rule (though, as noted above, the relevant language appeared in dicta⁷⁸). So, to the extent that the 1952 Congress held any belief at all about the prevailing law on patent license assignability, it probably thought 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 *Dopplmaier*? This, too, admits to a different reading than Quinn and Weide's. On both occasions when Congress was revising the relevant section of the Patent Act,⁷⁹ in 1975 and again in 1982,⁸⁰ it already would have known about the 1972 decision in *Unarco*, clearly stating (and not in dicta this time) that federal common law controlled questions of patent license assignability, even post-*Erie*.⁸¹ Here, again, Congress's inaction can be interpreted as tacit approval of the use of federal common law, rather than as tacit disapproval, as is urged by Quinn and Weide. Ultimately, this game of divining meaning from Congressional silence leads, at best, to a stalemate.

C. *What This Article Adds*

This Article distinguishes itself from these previous efforts to attack *Everex* in that it meets the *Everex* opinion on its own terms. This Article does not quarrel with the *Everex* court's skill in applying California state contract law to the license in question, nor does it take issue with the court's assertion that there is a federal policy favoring the preservation of the value of the patent monopoly. Instead, this

⁷⁷ The federal common-law rule was created in 1852 in *Troy Iron & Nail*, and was repeatedly invoked by federal courts between 1852 and 1952. See, e.g., *supra* note 38.

⁷⁸ See *Rock-Ola v. Filben*, 168 F.2d 919, 922 (8th Cir. 1948) (noting that the license at issue explicitly forbade the assignment in question, and thus removing any need to rely on the federal rule construing contractual silence against assignability).

⁷⁹ The obvious section in which one would overrule *Dopplmaier* is § 261 of the Patent Act, entitled "Ownership; assignment." 35 U.S.C. § 261 (2000).

⁸⁰ Quinn & Weide, *supra* note 5, at 1143.

⁸¹ *Unarco Indus., Inc. v. Kelley Co.*, 465 F.2d 1303, 1306 (7th Cir. 1972).

Article assumes that the patent license at issue in the *Everex* case would have been presumed assignable under California law, and takes *Everex* at its word that federal patent policy has an interest in maintaining the economic value of the patent monopoly, even against normal variations in state contract law.

But even if one grants the *Everex* court these core assumptions, its opinion is still susceptible to attack. And it is this critique of *Everex* on its own terms that is the main project of this Article. As shown 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 assignability post-*Erie*. To properly draw that conclusion, the *Everex* court would first have had to find that licensee bankruptcy was, empirically, a high-probability event. And neither *Everex* nor the existing critiques of the decision have even acknowledged that such an empirical finding was relevant.

VI. THE *EVEREX* COURT'S ERROR

A. *The Court's Failure to Consider the Probability of Licensee Bankruptcy*

Because *Erie* was a Supreme Court decision, lower courts can deviate from *Erie*'s broad proscription against federal common law only by invoking 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 that was cited (inappositely) by the *Unarco* court.⁸² The exception invoked by the *Everex* court 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*.⁸³ 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.'"⁸⁴ In a more precise statement of *Lear*'s reasoning, the *Lear* Court had explained that "[t]he decisive question [in *Lear* was] whether overriding federal policies would be significantly

⁸² See *supra* Part IV.B.

⁸³ 395 U.S. 653 (1969).

⁸⁴ *Everex*, 89 F.3d at 677 (citing *Lear*, 395 U.S. at 661-62, 673, additional citations omitted).

frustrated" if state contract law were allowed to control.⁸⁵ As noted in Part IV.C, when the *Everex* court applied this principle, it concluded 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."⁸⁶

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.'"⁸⁷ And in *Boyle v. United Technologies Corporation*, the Supreme Court said 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'"⁸⁸ On its face, the *Everex* decision appears to be a perfectly reasonable implementation of the "significant-conflict-with-a-federal-policy" exception to *Erie* that was articulated in *Lear*, *O'Melveny*, and *Boyle*. 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 state common law were to control, many states would (as California has done) impose a rule favoring assignability—one following the "state-law" pattern in Chart 2. And under § 365 of the Code, this would mean that a bankrupt licensee could assign its license to a third party, even when the license contained a no-assign provision. Undermining no-assign provisions can clearly reduce the value of the patent monopoly to its holder. Therefore, according to *Everex*, it significantly conflicts with federal policy, and must be prohibited.

⁸⁵ *Lear*, 395 U.S. at 673.

⁸⁶ *Everex*, 89 F.3d at 679.

⁸⁷ 512 U.S. 79, 87 (1994) (quoting *Wallis v. Pan Am. Petroleum Corp.*, 384 U.S. 63, 68 (1966)).

⁸⁸ 487 U.S. 500, 507 (1988) (quoting *Wallis*, 384 U.S. at 68). 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" in *Boyle* 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.

But this logic, straightforward as it seems, overlooks an important fact: Most patent licensees do not wind up in bankruptcy, and outside the special context of bankruptcy, state law gives *the very same result as the federal common-law rule*. Outside of bankruptcy, the Code does not apply, and there is no need to engage in the complex dance of § 365. Whether one is using state law or federal common law, the no-assign provision 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 seriously 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 scientist 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 be only in these rare cases that the no-assign provision will be undermined by the use of state law. This small chance of having the no-assign provision 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 value of the patent. If licensee bankruptcy is very unlikely, then the innovator's incentive to innovate would scarcely be affected by this improbable cataclysm.

It is as if the innovator is being promised (by Congress) the keys to a Rolls Royce if she discovers a useful, new, and non-obvious technology, and § 365 of the Code, in conjunction with state contract law, is imposing a one-in-a-thousand chance that the Rolls Royce the innovator wins will be a lemon. This small chance of winding up with a worthless Rolls Royce will scarcely dampen the innovator's incentive to expend effort and money on her research, because there is still a 999-in-a-thousand chance that the Rolls Royce will be a “non-lemon.”

The *Everex* court appears to have been lulled into assuming that all licensees would go bankrupt sooner or later, just because the particular licensee before the court that day

happened to have done so. "Allowing free assignability," the court warned, "would undermine the reward that encourages invention because . . . [i]n essence, every licensee would become a potential competitor . . . in the market for licenses"⁸⁹ But how is that relevant? The use of state law would not give "every licensee" the right to freely assign its patent licenses. At worst, it would only allow *bankrupt* licensees to do so. Non-bankrupt licensees must obey no-assign provisions under the state and federal rules alike, 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 for bankruptcy.⁹⁰ In that case, even if undermining a license's no-assign provision 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 rather than federal common law could not possibly reduce the *ex ante* expected value of a patent by more than one part in a hundred.⁹¹

Moreover, if our hypothetical assumption is correct that only 1% of the nation's licenses wind up in the hands of bankrupt licensees, then the *Everex* court may be subjecting the vast majority of licenses to federal common law, thus stripping from state legislatures and state courts powers that were supposedly safeguarded by *Erie*, just to avoid a bad result in the one-in-a-hundred case where the license ends up in the possession of a bankrupt licensee. 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 licenses end up being held by a bankrupt licensee. The point is simply to assert that the *Everex* court made no finding

⁸⁹ *Everex*, 89 F.3d at 679.

⁹⁰ A more complete analysis would consider not simply the fraction of licenses whose licensees were expected to declare bankruptcy, but the *value-weighted* fraction of licenses whose licensees were expected to do so. For instance, if 1/3 of the licenses were expected to wind up in the hands of bankrupt licensees, but all of those licenses turned out to cover nearly worthless technologies, the would-be innovator might not particularly care. Having one's no-assign provision stripped away by the courts only hurts if the underlying technology has real value.

⁹¹ 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 actors are not willing to pay an asset's expected value to acquire that asset, if the risk of the asset is non-diversifiable, because these actors will insist on some discount to compensate them for the hardship of bearing the risk itself. But, if the expected probability of bankruptcy is small, this correction for the cost of risk-bearing will be small as well.

at all on this critical empirical question. Had it looked into the matter and concluded that only a small fraction of patent licensees do, in fact, go bankrupt, the court's decision might well have gone the other way, even under the very same legal analysis.

Another way of viewing the problem is to start with the Coase Theorem, which says that, under ideal conditions, 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. Thus, if a license contains a no-assign provision, it is probably because a non-assignable license preserves more of the patent's total economic value than an assignable one would have done. And any rule of law that nullifies no-assign provisions—as long as these provisions arose out of costless and well-informed bargaining—reduces the expected economic value of the patent. By nullifying the no-assign provision only when the licensee is in bankruptcy, the use of state law clearly reduces the patent's *ex ante* expected value somewhat.⁹² What the *Everex* court failed to consider is that it might reduce that value only *very slightly*, not “significantly,” because licensee bankruptcy may, in fact, be quite rare.⁹³

⁹² As discussed in Part II, the use of state law amounts to a requirement that the licensor must give the licensee a kind of “bankruptcy insurance” along with the license. The cost of this insurance will be built into the fee structure of the patent license, and this will prevent certain otherwise value-creating licensing transactions from ever occurring. This is another way of saying that many licensees may not wish to purchase bankruptcy insurance, particularly from a licensor who cannot easily diversify the risk and is therefore forced to charge high premiums. Indeed, even at a fair price, this sort of insurance might be particularly unappealing to licensees, since the benefits of bankruptcy insurance are enjoyed mainly by a company's creditors, while the “premiums” (the licensing fees) are paid by its shareholders. (In theory the shareholders could recoup some of the premiums by borrowing on more favorable terms from exceedingly patent-savvy lenders, who understand that they are buying a bit of bankruptcy insurance along with their loans. But this seems far fetched.)

⁹³ One might ask whether this argument fixates unduly on the word “significant” in the *Erie* line of cases. Can the notion really be defended that a conflict between state law and federal policy must surpass some quantitative threshold—that it must be “significant”—before courts may impose federal common law? In fact, it can: The “significant conflict” test does impose a meaningful quantitative threshold.

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 said that federal common law was permitted when there was a “significant conflict” between federal policy and the use of state law. See *supra* notes 85-88 and accompanying text. Quinn and Weide also acknowledge 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.” Quinn & Weide, *supra* note 5, at 1143.

B. Robertson v. Wegmann: An Analytical Comparison

The Supreme Court made this same argument in another context in the 1978 case of *Robertson v. Wegmann*.⁹⁴ 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. Another federal statute, 42 U.S.C. § 1988, specifically requires that courts use the common law, constitution, and statutes of the forum state to fill legal gaps regarding suitable remedies in federal civil rights actions, except where such state laws are "inconsistent with the Constitution and laws of the United States."⁹⁵ Where they are inconsistent, by implication, federal common law must be applied. This "inconsistent-with-federal-law" standard might appear to be at least potentially different from the *Everex*-invoked standard, which calls for a "significant conflict" between state law and federal policy.⁹⁶ But in *Robertson v. Wegmann*, the Supreme Court explained that in looking for "inconsistencies" between state and federal law, "courts must

The notion of a quantitative threshold also squares with 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." *Boyle*, 487 U.S. at 518 (Brennan, J., dissenting) (quoting *Wheeldin v. Wheeler*, 373 U.S. 647, 651 (1963)). 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 almost always dream up an unlikely set of events that would render the doctrine inimical to federal policy.

Lastly, the Supreme Court itself has implicitly acknowledged the idea of a quantitative cutoff. 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 ordinary preemption," like the preemption used in *Everex*. *Boyle*, 487 U.S. at 507. This idea of different "degrees of sharpness" of the conflict implies that in the "ordinary preemption" cases, such as *Everex*, there is some minimum severity threshold for the conflict. (Otherwise, it is meaningless to say that the cutoff for the uniquely-federal-interest cases is lower.) See also *Chapman v. Westinghouse Elec. Corp.*, 911 F.2d 267, 269 (9th Cir. 1990) ("[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 . . ." (quoting *Boyle*, 487 U.S. at 507)); *Ill. Psychiatric Hosp. v. Health Care Serv. Corp.*, 1992 U.S. Dist. LEXIS 9607, *7 (N.D. Ill.) (applying the standard used in *Boyle*, and concluding 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).

⁹⁴ 436 U.S. 584 (1978).

⁹⁵ *Id.* at 587 (quoting 42 U.S.C. § 1988).

⁹⁶ See *Everex Sys. v. Cadtrak Corp. (In re CFLC, Inc.)*, 89 F.3d 673, 678 (9th Cir. 1996).

look not only at particular federal statutes . . . , but also at ‘the policies expressed in [them].’”⁹⁷ “Of particular importance,” the Court said, “is whether application of state law ‘would be inconsistent with the federal policy underlying the cause of action . . . ’” created by § 1983.⁹⁸ Thus, the test used by the Supreme Court in *Robertson v. Wegmann* turns out to be quite similar to the “significant-conflict-with-a-federal-policy” test used in *Everex*.⁹⁹

In *Robertson v. Wegmann*, the § 1983 suit had been brought in a Louisiana state court.¹⁰⁰ The plaintiff had died before the planned trial, and the executor of his estate had attempted to continue his civil rights action on the estate’s behalf.¹⁰¹ But Louisiana’s survivorship statute would have allowed the suit to go forward only if it had been brought on behalf of the plaintiff’s spouse, children, parents, or siblings, and no such relatives existed.¹⁰² Thus, the federal cause of action would have abated with the plaintiff’s death unless the federal courts could impose a federal common-law rule providing that a § 1983 action survives in favor of the plaintiff’s estate.¹⁰³

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.”¹⁰⁴ 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 federal policies seriously enough to warrant the use of federal common law. The Court wrote:

[G]iven that most Louisiana actions survive the plaintiff’s death, 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

⁹⁷ *Robertson*, 436 U.S. at 590 (citations omitted).

⁹⁸ *Id.* (citation omitted).

⁹⁹ *Everex*, 89 F.3d at 678.

¹⁰⁰ *Robertson*, 436 U.S. at 587.

¹⁰¹ *Id.* at 585.

¹⁰² *Id.* at 591.

¹⁰³ *Id.* at 588.

¹⁰⁴ *Id.* at 591 (citations omitted).

survivorship law would hardly be influenced in his behavior by its provisions.¹⁰⁵

The analogy to *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 matter before the Court in *Robertson v. Wegmann* happened to be one of those rare cases.¹⁰⁶ 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 a state official deciding whether to commit such a violation. But, as the *Robertson v. Wegmann* Court observed, because very few plaintiffs will die before trial leaving behind no spouse, child, parent, or sibling,¹⁰⁷ the cost of committing such a civil rights violation—from the *ex ante* perspective of the state official—would decline only slightly due to the use of the Louisiana rule. 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, because "most Louisiana actions survive the plaintiff's death"¹⁰⁸

This Article has made the same basic point 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 scarcely have 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.

¹⁰⁵ *Robertson*, 436 U.S. at 592.

¹⁰⁶ "Happened to be" is perhaps too glib. It is often the unusual, and doctrinally problematic, case that makes it to court—especially to the federal appellate courts and the United States Supreme Court. This is one reason why those courts must be especially careful not to presume that the facts before them are representative of the general case, as the Ninth Circuit seems to have done in *Everex*.

¹⁰⁷ *Robertson*, 436 U.S. at 591-92.

¹⁰⁸ *Id.* at 592 (emphasis added), quoted at greater length *supra* text accompanying note 105.

VII. THE MORE POWERFUL CRITIQUES OF THIS ARTICLE'S ARGUMENT

Built into the logic of this Article are some assumptions about the *Erie* exception invoked by the *Everex* court and about how the court applied that exception to the facts before it. This Part anticipates two concerns readers might have regarding these assumptions and shows that they do not undermine this Article's main argument. This Part also addresses the concern that the supposed "flaw" in *Everex*'s logic could have been solved trivially, by tailoring the federal common-law rule more narrowly, and that it therefore does not point to any need for an empirical analysis of the probability of licensee bankruptcy, of the kind called for in this Article.

A. *The Hypothetical Conflict Argument*

There is one potential reading of *Everex* that might, if it were correct, undermine the thrust of this Article. As we have seen, 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"¹⁰⁹ The phrase "allowing states to allow free assignability" suggests that perhaps the court was not claiming that California state law would *actually* create 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 provisions they might contain." Such a hypothetical law would frustrate *all* no-assign provisions in patent licenses, not just those in situations where the licensee was bankrupt. The "significant conflict" threshold might well be surpassed under such an extreme rule, even if it would not have been surpassed under the actual present-day law of California, which frustrates no-assign provisions only in cases of licensee bankruptcy.¹¹⁰

¹⁰⁹ *Everex Sys., Inc. v. Cadtrak Corp. (In re CFLC, Inc.)*, 89 F.3d 673, 679 (9th Cir. 1996).

¹¹⁰ I thank Prof. Barry Adler for pointing out this possible alternative reading of *Everex*.

But there is ample evidence that the *Everex* court was not referring to such "hypothetical state law." In particular, the court concluded 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."¹¹¹ The phrase "such as California's" strongly suggests that the court was thinking of the *actual* law of the State of California, not 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, rather than hypothetical law. For instance, in *Wallis v. Pan American Petroleum Corp.*,¹¹² the lower court 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"¹¹³ Thus, while state law could have hypothetically created a significant conflict with the federal policy, the use of federal common law was not warranted in *Wallis* 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.

B. The Argument that Everex May Have Been Addressing a Larger Universe of Licenses

This Article has focused on the reduction in the value of the patent monopoly that occurs when the license contains a no-assign provision which is overridden by the use of state law. But perhaps *Everex* can be read more broadly. Consider what would happen if the license were *silent* on the issue of assignability. In that case, the use of state, rather than federal, law would result in the license being assignable as well—

¹¹¹ *Everex*, 89 F.3d at 679.

¹¹² 384 U.S. 63 (1966).

¹¹³ *Id.* at 69-70.

regardless of whether the licensee was bankrupt. (See Chart 2 to confirm this.) If most patents with such “silent” licenses are, as an empirical matter, worth more when the law construes them to be non-assignable, then using state law will reduce the expected value of these patents on average. The issue then becomes whether the harm done to the patent monopoly by nullifying no-assign provisions in bankruptcy, *plus* the harm done, both in and outside of bankruptcy, by always construing “silent” licenses as assignable, combine to create a “significant” conflict with patent policy overall. The following chart may help clarify this point.

Chart 3: The Ultimate Outcome on Assignability in Every Possible Situation Being Considered, Both Inside and Outside of Bankruptcy

	Rule that governs outside of bankruptcy	License says “licensee may assign.”	License is silent on assignability.	License says “licensee may not assign.”
	↓			
Licensee is bankrupt.	State-law rule	Assignment permitted under Code.	Assignment permitted under Code.	Assignment permitted under Code.
	Federal common-law rule	Assignment permitted under Code.	Assignment not permitted under Code.	Assignment not permitted under Code.
Licensee is not bankrupt.	State-law rule	Assignment permitted under non-bankruptcy rule.	Assignment permitted under non-bankruptcy rule.	Assignment not permitted under non-bankruptcy rule.
	Federal common-law rule	Assignment permitted under non-bankruptcy rule.	Assignment not permitted under non-bankruptcy rule.	Assignment not permitted under non-bankruptcy rule.

In all three shaded regions of Chart 3, state law and federal common law lead to different results. In the above discussion, we have focused only on the cross-hatched region, where an explicit no-assign clause is overridden by the Code. But when the license is silent on assignability (middle column), the use of state law might threaten federal policy whether the licensee is bankrupt or not. It will threaten such policy in cases

where the parties to the "silent" license, had they thought of it, would have inserted a no-assign provision. If such cases are prevalent, then the middle column, on net, will represent a harm to federal policy. Even if the cross-hatched region alone did not represent a "significant" conflict with the overall federal policy (defined over the entire chart), perhaps adding the net harm from the middle column—i.e., from the silent licenses—would be enough to increase the conflict to above the "significant" threshold.

As noted, in the middle column the cases in which state law impairs federal policy are only those where the parties would have preferred the license to be non-assignable had they thought of the issue, but where they inadvertently left the license silent, opening themselves up to the hazards of state law and the vagaries of future courts' *Erie* analyses. Thus, as noted in Part II, it is likely that most of the patents represented in this middle column were not expected to be very valuable anyway. (Why else would the parties have left the fate of their licenses to chance?) Still, the middle column of Chart 3 may cover many more contingencies than the cross-hatched region: If the cross-hatched region represents a harm to *valuable* patents in cases of licensee bankruptcy, the middle column might represent an insult to lower-value patents over a much broader range of cases—i.e., whether the licensee is bankrupt or not. Perhaps these many small insults to federal policy add up to a net harm large enough not to be drawfed by the harm found in the cross-hatched region. Perhaps, then, we must consider these "silent" licenses as well, in determining whether the overall harm to federal policy is "significant."

In fact, there is language in the district court opinion in *Everex* suggesting that the lower court may have been considering licenses that are silent on assignability in addition to those with an explicit no-assign provision. In particular, the district court noted that "[l]imiting assignability to licenses in which the patent holder expressly agrees to assignment aids the patent holder in exploiting the patent"¹¹⁴ This certainly makes it sound as if the district court was considering the impact of state law on federal policy over the whole range of possibilities, including "silent" licenses.

¹¹⁴ *In re CFLC, Inc.*, 174 B.R. 119, 123 (N.D. Cal. 1994).

But the Ninth Circuit in *Everex* seems to have focused primarily on the cross-hatched region of Chart 3, as the following passage reveals:

As a practical matter 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.¹¹⁵

This language conveys the impression that the court was focusing on the harm done to patent holders who *knew beforehand* that they wanted to create a non-assignable license, and who therefore presumably would have inserted a no-assign provision.

But even if the Ninth Circuit had been thinking of the harm to federal policy found in all three shaded regions of Chart 3, the argument of this Article would still hold up. From the *ex ante* perspective, the innovator still must assess the likelihood that the situations described by the three shaded regions will come to pass in order to assess the expected value of his patent. And if the *Everex* court did not opine on the likelihood of the license ending up in the cross-hatched region, it certainly did not speculate about the probability of its landing in any of the three shaded regions. The point remains the same: The expected value of the patent, from the perspective of the would-be innovator, is tied to the probability of some future event or set of events, and a court considering the problem needs to opine on that probability.¹¹⁶

¹¹⁵ *Everex Sys., Inc. v. Cadtrak Corp. (In re CFLC, Inc.)*, 89 F.3d 673, 679 (9th Cir. 1996).

¹¹⁶ One might wonder: What does it mean for the would-be innovator to "assess" the probability that his patent monopoly will be harmed in the middle column of Chart 3? Surely, if he knows enough to make this assessment beforehand, he would simply insert the appropriate assignability language into the relevant license, thereby avoiding the middle column altogether. But would-be innovators do not always assess the future value of their patents through a formal forecasting process. They may, instead, become generally aware of the likely value of a patent based on experience and second-hand reports—journal articles, business-school lectures, and the like. If patent licenses in the middle column of Chart 3 are frequently interpreted by courts as being assignable, even though they would have been more valuable as non-assignable agreements, that information might easily slip into a would-be innovator's appraisal of the likely value of his own patent, even if the innovator had not thought rigorously about whether his particular patent would be more valuable if non-assignable.

C. *The "Narrow Tailoring" Point*

One might wonder whether this Article's critique of *Everex* could have been avoided by a more narrowly tailored application of federal common law. Suppose the *Everex* court had created a federal common-law rule that contractual silence should be construed against assignability only in cases where the licensee was bankrupt, leaving state law undisturbed otherwise. Could we still fault the *Everex* court for not opining on the probability of licensee bankruptcy?¹¹⁷

The answer is yes. Narrow tailoring and the "significant conflict" requirement are, in reality, separate issues. Even if a federal common-law rule is narrowly tailored, there remains the question of whether the insult to federal policy that occasioned this narrowly tailored rule was "significant," or not, relative to the overall federal policy—i.e., the federal policy considered over the entire range of its application. If not, then the federal rule violates *Erie*, no matter how narrowly tailored it may be.

In cases such as *Everex*, if the probability of licensee bankruptcy is low, then the effect of state law on the innovator's incentives would not be significant, and the federal courts would have no right to rectify this tiny harm by creating federal common law, even federal common law that is narrowly tailored. Certainly, if the *Everex* court had crafted its federal rule so that it applied only in cases of licensee bankruptcy, that would have eliminated the "tail wagging the dog" problem mentioned earlier.¹¹⁸ I.e., we would not be sweeping aside state law for all issues of patent license assignability to address a problem that occurred only when the licensee was bankrupt. And this might be better than creating an extremely broad federal rule to address a tiny harm. But cases like *Lear*, *O'Melveny*, and *Boyle* do not just prohibit the killing of a gnat with a sledgehammer. They prohibit the killing of an insignificantly bothersome gnat, by any means.

¹¹⁷ This point was raised by the staff of the Boston University Journal of Science and Technology Law.

¹¹⁸ See *supra* notes 91-92 and accompanying text.

VIII. CONCLUDING OBSERVATIONS

A. *The Recommended Approach for Courts Faced with Everex-type Questions in the Future*

Undoubtedly courts will continue to confront 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 reached in Part III: bankrupt licensees may assign their licenses notwithstanding a no-assign provision only if, outside of the bankruptcy context, questions of patent license assignability would be governed by state law rather than 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 invoked by the *Everex* court, permitting the use of federal common law when applying state law would "significantly conflict" with some federal policy. The relevant federal policy is that of the Patent Act, whose purpose is spelled out in the Constitution: "To promote the Progress of Science and the useful Arts . . . ," i.e., to encourage innovation.¹¹⁹ Thus, only when applying state law would significantly frustrate the incentive to innovate can one conclude that state law significantly conflicts with federal patent policy.

Reasonable judges will differ about how to decide what constitutes a "significant" conflict with the federally created incentive to innovate. For instance, one judge might ask, "By what fraction can state law reduce the expected value of the patent monopoly before it 'significantly frustrates' efforts to innovate by would-be patentees?" Another judge might feel that such subjective questions about how "innovative efforts" might respond to a given 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 will "significantly conflict" with federal policy *per se*.

¹¹⁹ U.S. CONST. art. I, § 8, cl. 8.

But whatever approach they take, judges who are confronted with patent license assignability questions must necessarily commit to some quantitative cutoff separating the "significant" conflict with federal policy from the conflict that is "insignificant." Courts need not settle on any particular number. They need not, for instance, proclaim that the conflict with federal policy becomes "significant" when the expected value of the patent drops by at least 10%, or 15%, or 20%. But even if the cutoff is an impressionistic one, a cutoff there must be, because if the expected value of the patent is reduced by a sufficiently small fraction, the diminishment will not create a significant conflict with federal policy and the *Erie* exception will not apply.

To decide whether the use of state law would push the patent's expected value below the relevant cutoff, the court must view the problem from the *ex ante* perspective of the would-be innovator. This scientist or R&D director is the true target of the federal incentive scheme, and therefore all that matters is his or her subjective appraisal of the likely decrease in patent value that will be caused by the use of state law.

To get inside the mind of the R&D director, the court will want to consider at least two empirically determined quantities. The first has already been discussed at length: the expected probability of licensee bankruptcy. To estimate that quantity, the court might look for an average bankruptcy rate of licensees across all industries, or it may want to use technology-specific bankruptcy rates. In any case, it would want to draw on expert testimony from economists who study innovation and those who study insolvency rates in various industries.

The second quantity the court should consider 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 frustration of the no-assign provision would reduce the patent's value by only, say, 20%, then the overall expected value of the patent might not decline significantly. We have not focused on this second quantity in the above discussion, mainly because the *Everex* opinion did appear to account for it, albeit informally.¹²⁰ (It

¹²⁰ The court seemed to feel that the reduction in a patent's value in cases of licensee bankruptcy would be very large. Compare *Everex Sys., Inc. v. Cadtrak Corp.* (*In re CFLC, Inc.*), 89 F.3d 673, 679 (9th Cir. 1996), where the court observed that if licenses could be assigned at will:

seems likely that the reduction in the patent's value will be fairly large in the general case, since a licensee that has already gone bankrupt will often have to sell the technology at a low price due to its distressed circumstances, thus providing stiff competition to the licensor in the market for patent licenses.)

Of course, the court's estimates of our two quantities—the probability of licensee bankruptcy and the expected drop in a patent's value in the event of such a bankruptcy—will be subject to the uncertainties that are endemic to all social science. And, as one can surmise even from this discussion, in reality the court will have to make some simplifying assumptions to avoid turning the bankruptcy proceeding into a kind of government-financed economics colloquium. Still, to ignore the empirical questions entirely, implicitly assuming that 100% of the nation's licensees wind up in bankruptcy—which is essentially what the *Everex* court did—hardly offers an attractive alternative.

B. Circumstances in Which the Problems of Everex Might Arise in the Future

As we saw in the case of *Robertson v. Wegmann*, the analytical framework of *Everex* is not limited to the problem of patent license assignability in bankruptcy. The logical errors of the *Everex* opinion can arise in many *Erie* analyses in which some federal policy applies to an entire range of persons or situations, at least some of which are ordinarily governed by state law. Within this range, there is some subset of situations, “S,” in which state law not only applies, but gives a result that tends to frustrate the federal policy. In *Everex*, the federal policy was an incentive policy: The federal government did not try to implement the desired behavior directly, but instead set up a system of rewards or punishments intended to motivate

[A]ny 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.

Id. at 679.

the targets of the incentive to adopt the desired behaviors on their own. (The reward offered by the government was the patent monopoly, and the desired behavior was the invention of useful technologies.)

In fact, focusing only on such "incentive policies" would not limit us too severely. A large number of federal policies, on careful consideration, turn out to be incentive policies. This is because governments tend to enforce their laws through imprisonment and forced property transfers, and many government policies do not identify these two activities as an ultimately desirable result. For example, one might argue that the federal government has a policy of reducing the quantity of cocaine imported into the United States. It expresses that policy, in part, by imprisoning importers of the drug. The federal goal is not imprisonment for its own sake, but rather, the reduction of cocaine imports. In the extreme, if all cocaine importers happened to have unusual tastes, such that they preferred incarceration to freedom, then the practice of imprisoning them would not advance the federal policy at all. So, the practice of imprisoning drug smugglers is an incentive to forbear from smuggling drugs, speeding tickets are an incentive to drive slower, and so on.

Incentive policies can be further broken down into two groups. In some cases, the target of the federal incentive, at the moment when he makes the decision that the federal government is seeking to influence, does not know whether he falls into subset *S* or not—i.e., he does not know whether the use of state law will frustrate the federal incentive *in his case*. *Everex* provides an example of such a situation. When the innovator is deciding how much effort to expend on her next invention, she has no idea whether her eventual patent licensee will end up in bankruptcy.

In these *Everex*-like scenarios, because the target of the federal incentive does not know whether she will end up in subset *S* or not, she is forced to play the odds. As a result, it is not just those who will eventually end up in *S* that see their incentives dampened. *Every* person subject to the incentive scheme will experience a watering-down of her expected punishment or reward, proportional to her own subjective assessment of her probability of falling into *S*. The *Erie* question, then, will turn on whether this partial dampening of incentives, experienced by all targets of the federal policy, is enough to create a "significant conflict" with the federal incentive policy overall. In other words, one must somehow

determine “by how much” the behavior of the incentive targets will deviate from what it would have been under an incentive scheme unburdened by state law. This is not just an elaborate way of restating the problem of patent license assignability in bankruptcy. As we saw in Part VI.B, the same logic also applied to the facts of *Robertson v. Wegmann*, and it would presumably apply to myriad other situations as well.¹²¹

The second group of incentive policies are those in which the target of the incentive *does* know, at the moment of decision, whether he is in *S* or not. The individual may be in some special category of persons who are covered by the state law that impairs the federal policy. In what is perhaps the most common case, *S* would simply comprise the persons or activities that are subject to the laws of particular states—those states that follow the state-law doctrine which dampens the federal incentive.

For instance, suppose the federal government institutes a program under which it intends to finance the construction of small airports in rural areas to encourage commercial activity. The federal government implements its policy by entering into numerous contracts with private real-estate developers around the country, under which each developer will build an airport and develop the surrounding land to accommodate business travelers. The federal statute authorizing this program specifically provides that each contract must contain a clause under which the developer promises to insure that the land around the airport will not be used for any purpose that would create a “hazard to air traffic.”¹²² This serves as a powerful disincentive, because, if anyone is injured or killed flying into one of these airports due to a hazardous land use, the injured parties and their survivors could sue the relevant developer for damages. Suppose, however, that in four of the 50 states,

¹²¹ In *Robertson v. Wegmann*, the Supreme Court explicitly acknowledged the potential significance of the fact that the target of the federal incentive did not know whether she would fall into *S* at the moment of decision:

In order to find even a marginal influence on [the civil-rights violator's] behavior as a result of Louisiana's survivorship provisions, one would have to make the rather farfetched assumption 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.

Robertson v. Wegmann, 436 U.S. 584, 592 n.10 (1978).

¹²² These facts are loosely adapted from the facts of the well-known case of *Miree v. DeKalb*, 433 U.S. 25 (1977).

ordinary contract law prevents such third-party beneficiaries of a contract from suing on the contract. In those states, the injured persons can sue only in tort, and must show actual negligence by the developer, which is far harder to prove than the "hazardous" use of the land. Developers in those four states clearly fall into what we have been calling the subset *S*. They know from the outset that they will not be strongly affected by the "hazard to air traffic" clause. (We are assuming that the contracts are governed by local law under valid choice-of-law principles.) The incentives of developers in the four problematic states are seriously dampened as they decide how the land is to be used, and the incentives of developers in other states are not dampened at all, because they know that they can be sued by third-party beneficiaries under applicable contract law.

In fact, this is the hallmark of the second category of "incentive policy" cases: The federal incentive is diminished with 100% probability for certain target persons (those who fall into the subset *S*) and is not diminished at all for all other persons. To do the *Erie* analysis in such cases, one must figure out whether the dampening of federal incentives *in certain circumstances only* is enough to create a "serious conflict" with the federal policy overall—i.e., as defined over all circumstances to which the policy is relevant. In the above example, if the four states with the unusual contract doctrines happen to be ones where few federally funded airports are being built, then the overall policy may not be "significantly" threatened by the application of state law. On the other hand, if nearly all of the planned airports are to be built in those four states, the federal policy is in danger of being utterly undermined.

Finally, one can encounter federal policies that cannot be described as "incentive policies" at all. These are policies in which the government's ultimate goal is accomplished by the direct action of the government itself, not by private actors motivated by government-provided rewards or punishments. For example, suppose the federal government is seeking to impose a nationwide tax that relies on some characterization that is a creature of state law: lawful title to certain property, say, or an individual's marital status. Alternatively, one can envision myriad direct federal expenditures that interact with state law. Consider, for instance, the rule under which federally insured student loans are denied to ex-felons. Some states might adopt a particularly lenient definition of a

"felony," frustrating the federal government's apparent desire to avoid educating people who have committed certain crimes.

In such situations, there is no "incentive." The federal government has pronounced some policy pertaining to its own direct action, and that action is being muted or frustrated in some way by variations in state law. Such policies do not need to be bifurcated according to whether the "incentive target" knows he will fall into the subset, *S*, of cases where state law frustrates federal policy, because there is no "incentive target." Rather than bifurcate these cases, one analyzes them all alike: by looking at the whole universe over which the federal policy is defined, and accounting for the fact that this policy will be frustrated with 100% certainty in some subset *S* of that universe and not frustrated, with equal certainty, in the remainder. Thus, the analysis resembles that of the second group of cases we considered: the cases of incentive policies in which the target of the incentive knows at the moment of decision whether he will be in *S* or not.¹²³

In each of the three types of cases just discussed (the two types of incentive policies and the non-incentive policies), courts may be tempted to repeat the error of *Everex*, by focusing narrowly on the circumstances of the litigants before them, rather than the effects of state law on the relevant federal policy over the whole range of possible circumstances to which such policy applies. The fact that *Everex* involved an incentive policy, in which the target of the incentive had to make her decision before knowing whether she would fall into the subset *S*, only adds an extra layer of technical difficulty to the court's *Erie* analysis. The basic idea of the analysis is the same for each of the three cases just described.

¹²³ In Part VI.B, the civil-rights case of *Robertson v. Wegmann* was analyzed as an illustration of an *Everex*-like incentive policy. But recall that the Supreme Court in that case said that the federal policy underlying 42 U.S.C. § 1983 included "compensation of persons injured by deprivation of federal rights" in addition to "prevention of abuses of power" by state officials. See *supra* note 104 and accompanying text. Although the policy of preventing future violations is undoubtedly an incentive policy, the policy of compensating victims is not. This "compensatory" policy is more akin to the third category of policies discussed just above: the non-incentive policies. (That the compensatory policy is not an incentive policy is clear from the fact that one could fully compensate victims of civil-rights violations out of a federally funded "discrimination insurance fund," thus completely vindicating the compensatory policy without discouraging future civil-rights violations at all.)

C. *Larger Implications of the Errors Found in Everex*

The missteps of the *Everex* opinion should concern us, as an initial matter, simply because *Everex* is an important case. As this Article has argued, *Everex* is the most authoritative decision in existence concerning the issue of patent license assignability in bankruptcy, and patent licenses are often among a bankrupt company's most valuable resources. If *Everex* was wrongly decided, other courts should know about it, so that they do not simply follow the logic of *Everex*, including its failure to account for the probability of licensee bankruptcy.

But as we have just seen, *Everex*'s shortcomings may be emblematic of a larger problem. Whenever a court applies the "substantial-conflict-with-a-federal-policy" exception to the *Erie* doctrine, it must always assess the degree to which the application of state law frustrates the relevant federal policy, and in doing this, it must be careful to consider the effects on the federal policy *over the entire range of fact patterns to which it applies*, not just to some subset of those cases. In particular, the court must take its focus off of the case before it, because the litigants who happen to be before the court may fall into some special category for which the application of state law is particularly inimical to federal policy. If they do fall into such a category, then focusing narrowly on the facts before the court may lead to the over-proliferation of federal common law.

Courts, like other organs of government, will often err on the side of expanding their own power in close cases. It is probably no coincidence that the four federal circuit courts that have considered the patent license assignability issue since *Erie* all concluded that federal common law should control, whereas the Supreme Court of California, a state court, came to the opposite result (in *Dopplmaier*). Cases such as *Everex* provide judges with a tempting opportunity to expand their power, by inviting them to focus narrowly on the case at hand, rather than looking at the federal policy overall.

Even if that is true, one might say, why should we really care if federal courts stretch the meaning of *Erie* a bit, leading to a few unwarranted exceptions to *Erie*'s presumption against federal common law? We should care for at least two reasons. First, there is the preservation of separate spheres of power for the legislature and judiciary that lies at the core of our government's design. Federal judges are appointed officials, with unique powers to act coercively in individual cases, and as a result we limit their law-making power to the interpretation

of existing federal statutes and the federal Constitution. More freewheeling creation of new laws is better done by legislators, for any number of reasons, including the facts that (i) legislators need to be re-elected and will therefore avoid enacting rules with vastly unpopular effects, (ii) legislators have much broader powers to investigate the potential effects of a proposed rule on parties who may not be before them, and (iii) legislators have the freedom to wait until the effects of a proposed rule are well understood before acting, while judges are forced to act speedily in the context of a particular ongoing dispute. Of course, these reasons only apply when the state law in danger of being overridden by federal common law is of legislative, rather than judicial, origin.

A second problem with the unwarranted promulgation of federal common law—one that applies regardless of whether the state law being eclipsed is judicial or legislative in origin—is that federal common law puts an end to state-by-state experimentation in how the law approaches certain social problems or goals. Where Congress has remained silent on an issue within its law-making power, this may be because Congress could not think of a particular approach that it considered superior to all others. One way to find out which approach works best—and, indeed, to find out whether the best solution involves myriad approaches in different geographic regions—is to cede control to state legislatures and state courts and see what emerges. If such state-by-state experimentation eventually points to a clearly superior approach, or reveals the need for nation-wide uniformity, Congress can act at that time.

In a contract issue such as the one under consideration in *Everex*, it might be said that state-by-state experimentation is particularly valuable. If various states take diverse approaches to an issue, the parties to the contract can choose the approach that best suits them, by agreeing that the law of State X or State Y will govern their contract. Choice-of-law principles will not always permit the parties to select their favorite state-law doctrine of the 50 available, but the parties will certainly have a wider array of choices under the state-by-state approach than they would if they were forced to follow a single federal rule.¹²⁴

¹²⁴ See RESTATEMENT (SECOND) OF CONFLICT OF LAWS (1988 Revisions), § 187 (setting forth general principles dictating when the parties to a contract can choose the state-law doctrine under which their contract will be construed).

Note that the *Everex* court put a stop to state-by-state experimentation not

With regard to *Everex* itself, it is worth noting that we really do not know what would occur if states were left to create their own law of patent license assignability. As discussed *supra* at note 34, the Restatement (Second) of Contracts leaves room for state courts to deny assignability in the face of contractual silence whenever assignment of the contract would "materially increase the burden or risk imposed on [the obligor] by his contract, . . . or materially reduce its value to him."¹²⁵ This language seems sufficiently flexible that it might allow courts to deny the assignability of patent licenses that are silent on the issue of assignability, in situations where assignment would significantly diminish the overall value of the licensor's patent monopoly. The Restatement (Second) also bars assignments that are "inoperative on grounds of public policy."¹²⁶ Thus, some state courts might be able to construe a license as non-assignable by invoking the very same patent policy that underlies *Everex*, without any help from federal common law.

It is certainly not the position of this Article that issues of patent license assignability should be left to the states. If federal displacement is needed to prevent some significant conflict between state law and patent policy, then federal law should apply. But federal courts that consider the issue in the future should give the "significant conflict" question a fair hearing—including a frank assessment of the probability of licensee bankruptcy—before deciding to eclipse state law in favor of their own.

just in cases of licensee bankruptcy, where one might say the Code expresses a federal policy of overriding the parties' choice of law on assignability issues, but also in cases where the licensee is not bankrupt.

¹²⁵ RESTATEMENT (SECOND) OF CONTRACTS § 317(2) (1979).

¹²⁶ *Id.* at § 317(2)(b).