

**Avoiding Problems Arising From Licensing
With Troubled Companies:
Issues at the Interface Between Intellectual
Property Law And Insolvency Law**

Gerry J. Elman

Elman Technology Law, P.C.
Swarthmore, Pennsylvania



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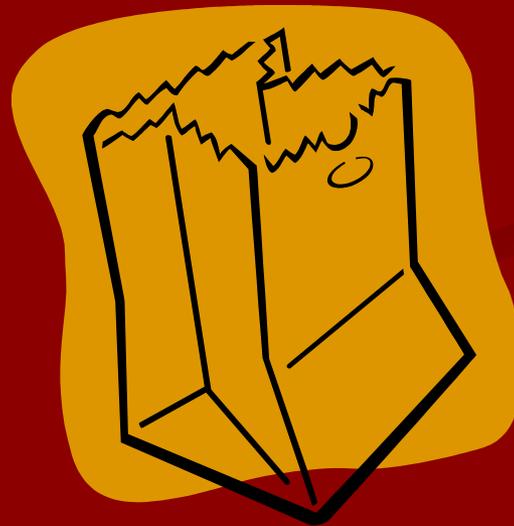
What happens when ...

- the bubble bursts?



Who's left ...

- holding an empty bag?



This talk will be about ...

- How to prevent ...
- Or at least minimize ...
- That eventuality.



What can you do ...

- To keep your licensed Intellectual Property safe?
- Even when your licensor or licensee goes bust.



Outline

- Overview of U.S. Bankruptcy Code as it affects IP licenses
- The Intellectual Property Bankruptcy Protection Act of 1988
- How to avoid potential problems with insolvency when negotiating & drafting licensing agreements

Underlying policy of Bankruptcy Code

- To maximize payments to creditors
- To provide the trustee or debtor-in-possession broad powers for reorganization or liquidation
- Bankruptcy creates problems for unsecured non-debtor parties to a license agreement

Bankruptcy Jargon

- Debtor
 - The party that winds up in bankruptcy
- Executory contract
 - A contract wherein each party has an obligation yet to be fulfilled
- Assumption of a contract
 - Formally accepting continuation of the contract
- Rejection of a contract
 - Tearing it up as part of the bankruptcy



The infamous *Lubrizol* case

In *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985):

- RMF granted Lubrizol a nonexclusive license to utilize a metal coating process technology.
- RMF filed for bankruptcy under Chapter 11 and rejected the license because the agreement was executory and as the debtor licensor, RMF had the right to reject
- Licensee Lubrizol was left with the right to seek monetary damages (from the bankrupt estate) for the breach, but no specific performance



For an insolvent licensor, the right to reject a license agreement, although consistent with policy of bankruptcy code, has a devastating effect on the licensee –

- If the licensee's business is dependent upon licensed technology, rejection could shut down operations
- Debtor can use threat of “rejection” to renegotiate the license
- Licensee is in limbo until the licensor decides to either assume or reject the contract
- Seeking a license elsewhere may constitute a breach

If the law supposes that ...

- The law is a ass.



“If the law supposes that,” said Mr. Bumble,... “the law is a ass—a idiot. If that’s the eye of the law, the law is a bachelor; and the worst I wish the law is that his eye may be opened by experience—by experience.”

Charles Dickens,
Oliver Twist (1837)



Intellectual Property Bankruptcy Protection Act of 1988, 11 U.S.C. 365(n) Amendment to US Bankruptcy Code

- Congress' response to *Lubrizol Enterprises v. RMF*



- Intended to protect interests of a patent or copyright licensee when licensor goes into bankruptcy

Response to the *Lubrizol* decision



- Congress added a definition for “intellectual property”
 - Applies to trade secrets, patent applications, patents, copyrights and mask works
 - But does **not** include trademarks or trade names

- Added §365 (n) – defining rights and obligations of non-debtor/licensee and debtor/licensor if licensor rejects executory license agreement



Selected provisions of the U.S. Bankruptcy Code

11 U.S.C. §365(a) - A debtor may assume or reject an executory contract.

Determination of whether a license is executory:

- Made at the time of filing for bankruptcy.
- Contract is considered in its entirety
- Fact-specific and depends on the particular terms of the agreement.
- If both parties have virtually any ongoing obligations, a license agreement is considered an executory contract



Selected provisions of the U.S. Bankruptcy Code

11 U.S.C. §365(b) - To assume a contract, a debtor must demonstrate financial responsibility. (3 prong test)

- Cure all defaults under the contract or provide adequate assurance that any defaults will be cured promptly

AND

- Compensate or provide adequate assurance that it will promptly compensate any third party to the contract for any defaults

AND

- Provide adequate assurance of future performance



Selected provisions of the U.S. Bankruptcy Code

Deadline for debtor to assume the contract under §365(b)

- Chapter 7 –within 60 days of the bankruptcy petition (Court can extend deadline)
- Chapter 11 – can be assumed at any time prior to confirmation of a plan of reorganization, but any party may seek to have the Bankruptcy Court impose a deadline or compel the assumption or rejection of the contract.



Selected provisions of the U.S. Bankruptcy Code

11 U.S.C. §365(f) – A debtor may **assign** a contract to a third party if

- The contract is properly **assumed** under §365; and
- **Adequate assurance of future performance** by the assignee is provided.

11 U.S.C. §363 allows a debtor to sell the intellectual property upon notice and a hearing.



Selected provisions of the U.S. Bankruptcy Code

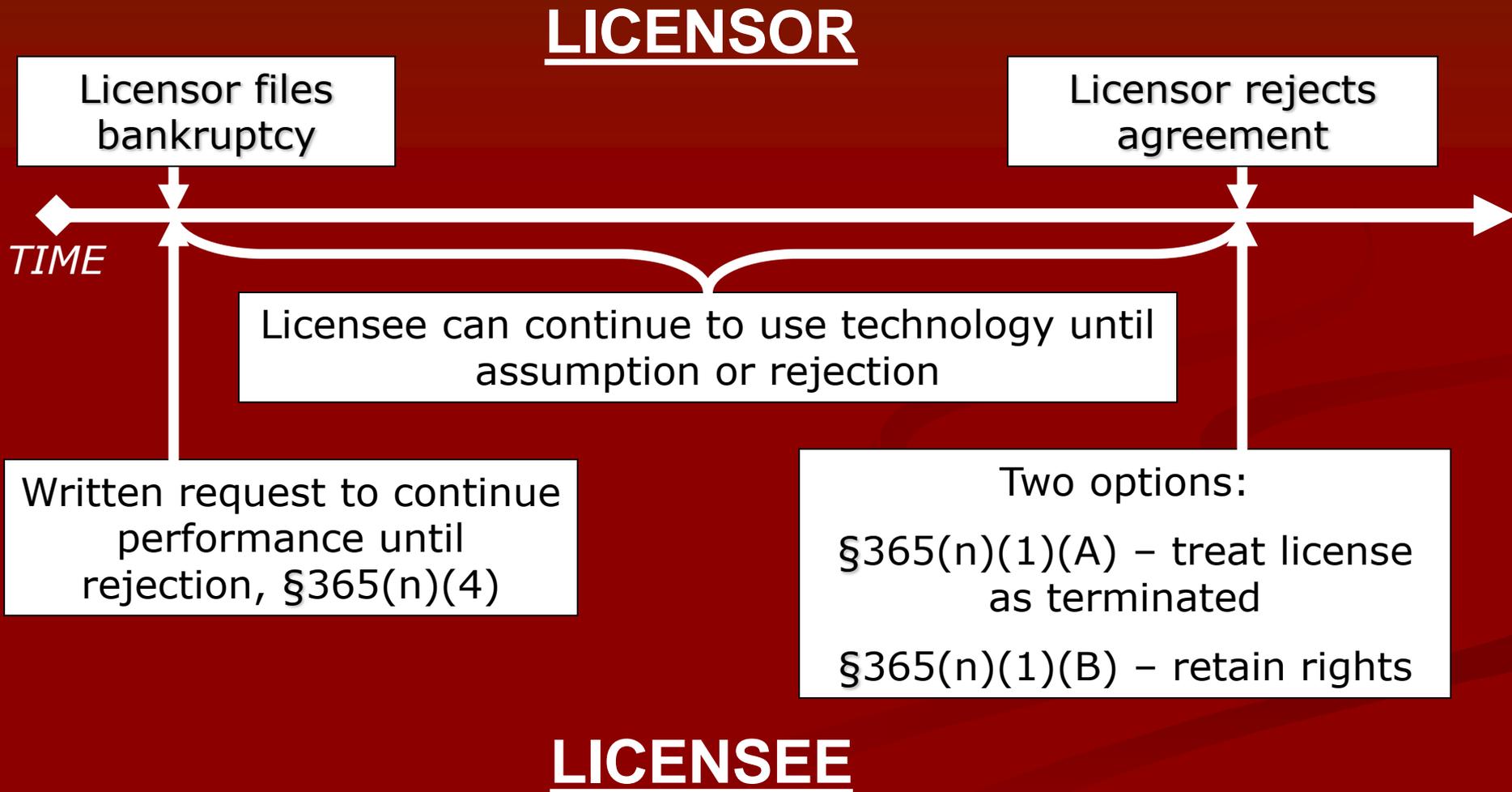
11 U.S.C. §365(c)- A debtor **cannot assume or assign** an executory contract if

- Applicable law excuses a party to the contract, other than the debtor, from either accepting performance from or rendering performance to an entity other than the debtor whether or not the contract specifically restricts such assignment of rights or delegation of duties

AND

- That party does not consent to the assumption or assignment

Sequence of events under § 365(n)



Licensee's choices under §365(n)

Two options for licensee upon rejection:

- § 365(n)(1)(A) - Licensee treats license as terminated, seeks monetary damages for breach in a general unsecured claim against the bankruptcy estate

OR ELSE

- § 365(n)(1)(B) - Licensee can retain rights under license (and any supplementary agreements) as they existed immediately prior to bankruptcy filing for the remaining life of the license plus any renewal or extension period

If the licensee retains its rights under the license agreement

- Licensee cannot enforce use of post-bankruptcy improvements or modifications (disadvantage for software licensee)
- Licensee must continue to pay royalties, §365(n)(2)(B)
- Licensee must waive right to set off claims that arise from licensor's failure to perform, §365(n)(2)(B)-(C)
- Licensee may recoup loss in value of rights due to failure of the licensor to perform
- Debtor/Licensor is relieved of performing any ongoing or future affirmative obligations
- Debtor/Licensor is not relieved of passive obligations

Issues Arising from 1988 Intellectual Property B.P.A

What are **royalties**?

- 9th Circuit broadly interpreted royalties to encompass all payments to use a license, *In re Prize Frize, Inc.*, 32 F.3d 426, (9th Cir. 1994).
- Non-debtor/licensee may be forced to pay both royalties and license fees to continue using a rejected license

Issues Arising from 1988 Intellectual Property B.P.A

Non-exclusive licensees may have no protection from infringing competitors

- If a debtor/licensor rejects a license, it is relieved from any future affirmative obligations
- The licensor is therefore relieved of enforcing the patent by suing potential infringers
- A non-exclusive licensee has no standing to sue a potential infringer

Issues Arising from 1988 Intellectual Property B.P.A

Licenses may be interpreted as sales agreements if there is no post-petition consideration for a pre-petition debt.
In re DAK Industries, Inc., 66 F.3d 1091, (9th Cir. 1995)

- Debtor/licensee can continue to use license after bankruptcy filing without paying fees
- Non-debtor/licensor forced to file non-priority unsecured claims for post-petition payments

Issues Arising from 1988 Intellectual Property B.P.A

Buying intellectual property from a bankrupt licensor may not entitle the new owner to royalties. In re Cellnet Data Systems, Inc., 327 F.3d 242 (3d Cir. 2003).

- Occurs when an entity buys intellectual property from a debtor/licensor, but does not assume any prior obligations or accept them by assignment
- If the licensee decides to retain its rights under §365(n), royalty payments will go to the debtor and not the new intellectual property owner

Issues Arising from 1988 Intellectual Property B.P.A

The separate treatment of licenses under §365(n) may devalue the licenses as a unit (In re Centura Software Corp., 281 B.R. 660 (Bankr. N.D. Cal. 2002)).

Example: Licensee acquires a copyright and trademark license to produce and sell software

- If debtor/licensor files for bankruptcy and rejects, licensee can continue use of copyright under §365(n), but may lose right to use the trademark which is not protected under the code
- Disadvantage for debtor – the value of packaged license agreements are greater than its parts, but debtor will be unable to offer package exclusively to third parties during reorganization
- Disadvantage for non-debtor – inability to use trademark results in loss of goodwill associated with copyrighted product

Issues Arising from 1988 Intellectual Property B.P.A

Circuit split on application of §365(c)

“Hypothetical” test

vs.

“Actual” test

“Hypothetical” test

Adopted by:

3rd Circuit, *In re West Elec. Inc.*, 852 F.2d 79 (3d Cir. 1988)

4th Circuit, *In re Sunterra Corp.*, 361 F.3d 257 (4th Cir. 2004)

9th Circuit, *In re Catapult Entertainment, Inc.*, 165 F.3d 747 (9th Cir. 1999)

11th Circuit, *In re James Cable Partners*, 27 F.3d 534 (11th Cir. 1994)

- Applies literal interpretation of §365(c)
- **Even if debtor does not intend** to assign an executory license to a third party, debtor cannot assume a license without consent, if applicable law would bar assignment.
- Applicable law – because of exclusive rights associated with a patent or copyright, licensee must obtain consent prior to assuming a patent license or non-exclusive copyright license.

“Actual” test

Adopted by:

1st Circuit, *Institut Pasteur v. Cambridge Biotech Corp*,

104 F.3d 489 (1st Cir. 1997)

5th Circuit, *In re Mirant Corp.*, 440 F.3d 238

(5th Cir. 2006)

- Assumption only prohibited if licensor is actually forced to accept performance from a third party.
- A debtor, not a trustee, can assume possession of a license without consent

Issues Arising from 1988 Intellectual Property B.P.A.



Assignability of a patent license under §365(c)

- Once the license is **assumed**, terms in a license restricting assignments are generally unenforceable; therefore, some other applicable non-bankruptcy law must determine assignability of a license
- If federal common law decides questions of assignability, a licensee is prohibited from assigning the license
Everex Systems, Inc. v. Cadtrak Corp., 89 F.3d 673 (9th Cir. 1996)
- If state law governs assignability, a licensee is allowed to assign a patent license
Superbrace, Inc. v. Tidwell, 21 Cal. Reporter 3d 404 (Nov. 23, 2004)

Trademarks, 365(c), and the “Hypothetical” Test

- Possible trend where courts are holding that trademarks are not assignable in Chapter 11 bankruptcy without the consent of the licensor.
 - *In re Wellington Vision, Inc.*, 2007 WL 762398 (S.D. Fla. 2007)
 - *Blanks v NCP Marketing Group, Inc* 337 B.R. 230 (D. Nev. Nov. 21, 2005)
 - *In re Travelot Co.*, 286 B.R. 447, 455 (Bankr. D. Ga. 2002)
- The “hypothetical” test for 365(c)(1) bars the ability of the debtor to assume a license without consent if applicable law would bar assignment.
- Here the “applicable law” is federal trademark law (15 U.S.C.A. § 1051 et seq.)

Trademarks, 365(c), and the “Hypothetical” Test

- Results of this trend coupled with the “hypothetical” test:
 - Effect on debtor licensee:
 - Cannot retain a trademark license without the licensor’s consent.
 - Possibly reduces the value of the licensee’s bankruptcy estate because the license also cannot be freely assigned.
 - Effect on non-debtor licensor: Contractual provisions requiring licensor’s consent to licensee’s assignment are no longer nullified by licensee’s petition for bankruptcy.

How to protect a licensee's interest when the licensor is the debtor



- The following suggestions may help a licensee to a better position than otherwise, in the undesired circumstance that its licensor files for bankruptcy.
- Due to the nature of bankruptcy, particularly the ability of the trustee or debtor in possession to reject the provisions of a license agreement, these suggestions couldn't guarantee a licensee as good a relationship as before bankruptcy. But they would provide an opportunity for additional protection via the limited remedies under Section 365(n).



How to protect a licensee's interest

- Expressly retain right to exercise rights under Section §365(n) in the event of the bankruptcy of licensor
- State that the rights and licenses granted under the license concern “intellectual property” as defined under §101(35A) of the Bankruptcy Code



How to protect a licensee's interest

If license involves software, obtain a present right to

- Use and repair the intellectual property.
- Make derivative works as of the effective date of the license, even if the licensee is not in possession of the source code.



How to protect a licensee's interest

Include sufficient ongoing duties, so that the license will be deemed “executory” in the event of a bankruptcy filing.

- Duty to notify the licensee of patent infringement suits
- Duty to defend the licensee against infringement claims
- Indemnities and warranties for licensee
- Duty to account for and pay royalties to licensor
- Duty to maintain books and records for licensor
- Confidentiality agreements



How to protect a licensee's interest

Create separate agreements for:

- Trademarks and trade names, which do not fall within the Bankruptcy Code definition of “intellectual property”
- Affirmative obligations imposed upon the licensor, such as maintenance and support services, to which §365(n) does not authorize the licensee to retain rights.



How to protect a licensee's interest

- Include a statement that failure by the licensee to assert its rights to benefits provided by §365(n) will not be deemed a termination of the agreement in the event that it is rejected by the licensor.
- Create a provision that enables licensee to obtain training, support, and maintenance from a third party if licensor decides to reject license



How to protect a licensee's interest

Create a separate technology escrow agreement

- Cross-reference the license agreement
- Refer to it as a supplemental contract as provided in §365(n)
- Name a third party escrow agent to retain source code, upgrades, and modifications
- Structure as two separate agreements – licensor and escrow agent / licensee and escrow agent
- Include audit provisions and customary requirements concerning storage and maintenance of software
- Specify trigger conditions for automatic release of the source code to the licensee, such as the cessation of business operations or failure to support the licensed property



How to protect a licensee's interest

Negotiate clearly and narrowly defined royalty payments.

- Separate royalty fees from fees for other ongoing services, such as maintenance, service, or upgrades; or
- Provide that royalty payments are reduced to the extent that the licensor fails to perform services

Load royalty payments toward end of license term to encourage assumption of license by debtor-licensor



How to protect a licensee's interest

Define the term “event of default” to include:

- Licensor's rejection of contract under §365(n)
- Non-financial events that may occur during the automatic stay after filing bankruptcy
- Specifically state licensee's right to terminate the agreement as a remedy for these defaults.

Define “adequate assurance of future performance” to avoid a dispute as to whether a licensor should assume and assign the license

Provide that in the event of a sale by the licensor under §363, if assignment does not account for licensee's needs, licensee objects to the sale and demands adequate protection

How to protect a licensor's interest when the licensee is the debtor



- The following suggestions are meant to improve the position of the licensor if a licensee files for bankruptcy.
- Again, the bankruptcy code provides the trustee or debtor in possession great power to reject the provisions of a license agreement, but these suggestions may help a licensor to a better position than otherwise, via provisions of Section 365 or other law.



How to protect a licensor's interest

Avoid rejection by a licensee and increase an unsecured claim by including

- Early termination fees
- Liquidated damages provisions
- Acceleration of future royalties upon rejection

Consent to future assumption of the license during a bankruptcy proceeding, unless there is a change of control



How to protect a licensor's interest

Include provisions that demonstrate that the license is an agreement that cannot be assumed or assigned without consent (avoid “exclusive” licenses if possible)

Include sufficient ongoing duties, so that the license will be deemed “executory”

Draft the agreement to resemble a personal services agreement to provide a justification under contract law to refuse performance by a third party

- State that agreement is not assumable or assignable in bankruptcy without consent
- Provide explanations as to why licensor chose the licensee and define acceptable performance



How to protect a licensor's interest

Prevent assignment to an unacceptable third party or competitor by drafting provisions applicable to the original and any subsequent assignee

- Include benchmarks to ensure the proposed assignee can generate value from the license.
- Consider provisions that would cause termination upon an acquisition or change in control of the licensee.
- Define “adequate assurance of future performance” under §365(f)
- Incorporate non-compete clauses into the license to avoid assignment to competitor.



How to protect a licensor's interest

Include provisions that will enable licensor to terminate a license prior to a bankruptcy proceeding

- Tie to credit or other financial agreement.
- Enable termination upon repeated breaches, such as
 - Failure to meet projected sales
 - Change in business plan
 - Late payments
- Impose a short term for the license

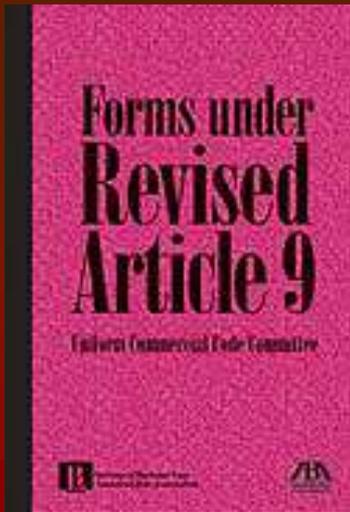
Additional suggestions for both parties



A licensor should obtain a **security interest** in **embodiments** of the intellectual property

A licensee should obtain a **security interest** in the intellectual property

Security Interests



Article 9 of the U.C.C. was revised, as of July 1, 2001

“General intangible” may be recited in the description of property and includes IP, whether owned or obtained by license.

“Location” of a corporate debtor is place of incorporation, not its headquarters.

See **Forms under Revised Article 9**, ABA Uniform Commercial Code Committee (2002)(paperback book with forms on CD-ROM)

Where to File?



- Trademarks, unregistered copyrights, trade secrets, Internet domains – file a UCC1 in the debtor's state
- Registered copyrights - file Security Agreement in the Copyright Office
- Patents - file both a UCC1 in the debtor's state and a Security Agreement at the PTO



Additional suggestions for both parties

Exclude intellectual property from bankruptcy estate

- Purchase the intellectual property rather than a license (be sure to either assume any licenses to third parties or specify that owner will receive royalties)
- Determine whether licensor can create an independent trust or entity separate from the bankrupt entity to administrate the intellectual property.

Routinely investigate status of licensees and licensors.

- Review or audit financial statements
- Monitor litigation that could lead to bankruptcy

For Further Information ...

- Visit <http://www.elman.com>
- Call Gerry Elman at (610) 892-9942
- Send email to gerry@elman.com

Elman Technology Law, P.C.

PO Box 209

Swarthmore, PA 19081