Licensing issues in today's bankruptcy world

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INTRODUCTION

As bankruptcy cases have developed over the years, so has their impact on the treatment of licenses been felt by the counterparties thereto. This has been especially true in cases where the licensee's business relies on the rights granted from the debtor–licensor.

This article examines the impact of federal bankruptcy law on licensing counterparties and provides guidance to licensees and licensors regarding preservation of their respective rights in connection with a bankruptcy filing. In so doing, this article provides an overview of the legal framework of the bankruptcy process, including a discussion of Bankruptcy Code section 365(n), and then discusses drafting and negotiation tips that industry counterparties can use to assist in the protection of their interests in the event of a bankruptcy filing.

BANKRUPTCY FRAMEWORK

Bankruptcy Code section 365 governs a debtor's rights and obligations with respect to the treatment of its 'executory contracts'.[1] Although not every license agreement is an executory contract (that is, an agreement where material unperformed obligations of the parties exist as of the bankruptcy filing),[2] most bankruptcy courts treat intellectual property licenses and technology agreements as executory contracts, as we will do for purposes of this article.

Following a bankruptcy filing, a debtor generally has three options with respect to the treatment of its license agreement. The debtor may either assume the license agreement, reject it or assign the license agreement.[3] Which option the debtor exercises, and at what stage of the bankruptcy, will depend, in part, upon the facts and circumstances of the case, and will involve, among other things, the debtor's performance of a cost-benefit analysis with respect to each agreement.

Assumption of a license means the debtor wishes to retain the agreement. In so doing, the debtor cannot 'cherry-pick' among the various provisions of the agreement and must assume all of the benefits and burdens that exist as of the bankruptcy filing.[4] As a condition of assumption, the debtor must also cure all defaults, monetary and non-monetary, under the license agreement and provide adequate assurance of future performance to the non-debtor counterparty.[5] Adequate assurance generally requires evidence that the debtor has both the financial wherewithal and operational proficiency to perform under the agreement on a going forward basis.[6]

Rejection of a license agreement means that the debtor wishes to be relieved of any further obligations thereunder. Rejection, like assumption, is of the entire agreement, and although it generally relieves the counterparties of their contractual obligations, those parties also lose their rights and benefits under the agreement, which result could have a devastating effect upon the non-debtor licensee.[7] Upon rejection, the license is deemed breached as of the date immediately

before the bankruptcy filing, and the non-debtor licensee is generally limited to the filing of an unsecured claim for damages (in bankruptcy dollars) against the debtor's estate.[8]

Licensors used such relief to their tactical advantage, and these situations came to a head in the 1986 landmark case of *Lubrizol Enterprises Inc.* v. *Richmond Metal Finishers*, where the court, among other things, permitted the debtor–licensor to reject a license, resulting in a complete rescission of the technology transfer to the licensee, notwithstanding the significant time, effort and funds expended by the licensee to procure and market the technology.[9] As a result, licensors used bankruptcy as both a sword to eliminate unprofitable licenses and a shield against licensees' claims. This phenomenon came to be known as the 'Lubrizol Effect'.

SECTION 365(N) OF THE BANKRUPTCY CODE

In 1988, Congress enacted Bankruptcy Code section 365(n) to reverse the *Lubrizol Effect* and to provide a non-debtor licensee of 'intellectual property' facing rejection the power to either (a) treat the license as terminated and receive a bankruptcy claim for its damages or (b) retain its license rights under certain conditions set forth in section 365(n).[10] This was a major protection granted to a licensee, but the benefits of section 365(n) are limited to situations where the licensor is the debtor.[11]

Section 365(n) applies if each of the following three conditions exist: (a) the debtor is a licensor, (b) the license is for 'intellectual property' as defined by the Bankruptcy Code and (c) the license has been executed before the commencement of the bankruptcy case.[12] The Bankruptcy Code definition of 'intellectual property' includes patents, copyrights, trade secrets and semi-conductor chip mask works.[13] For reasons beyond the scope of this article, the definition excludes trademarks, trade names, service-marks and foreign intellectual property.[14]

Pending assumption or rejection, a debtor is generally required to continue to perform under a license to the extent provided in the agreement. If the debtor ultimately decides to assume the license, then the normal rules of assumption apply. However, in the case of rejection by a debtor–licensor, the licensee now has two options available as a result of section 365(n): (a) the licensee can treat the license as terminated and assert a unsecured damages claim consistent with past practices, or (b) the licensee may retain its rights under the license for the term of the agreement and any extensions thereof, but only with respect to those rights existing as of the licensor's bankruptcy filing.[15] The licensee will have no rights to property developed after the bankruptcy filing, even if the rejected license otherwise provides for such improvements.[16] The licensee's deadline to exercise such election is often set forth in the debtor's rejection papers, but if no period is specified, the prudent course is to provide clear and certain notice at the time of or soon after rejection.

To retain its rights, the licensee must continue to make all 'royalty' payments for the duration of the agreement, and waives its right of offset and its right to seek payment from the debtor for any post-bankruptcy filing claims.[17] What constitutes a royalty payment is generally determined based on the substance of the transaction rather than the payment label contained in the license.[18] However, as discussed below, courts will take into consideration the plain meaning of the license provisions in deciding whether such payments are required by the licensee under section 365(n). As for other payments required under the license, to the extent they are for 'affirmative' ongoing obligations of the debtor–licensor (for example, maintenance, marketing and technical support), the licensee will not have to make such payments given that the debtor–licensor will be relieved of such obligations post-rejection.[19]

Under section 365(n), the licensee will be able to exercise its rights under the license, but cannot demand specific performance from the debtor–licensor or obtain post-petition upgrades or modifications to the intellectual property.[20] This may significantly reduce the value of the license and can pose problems for the licensee. However, to help address this situation, section 365(n) requires the debtor–licensor to provide the licensee, upon its request, with all intellectual property held by it to the extent provided under the license and any ancillary agreements.[21] This allows the licensee to, among other things, retain third parties for the services and support that the debtor–licensor is no longer required to perform.

LICENSEE DRAFTING TIPS

Taking into account section 365(n) and the general legal framework discussed above, here are certain drafting tips a licensee should consider in negotiating a license agreement.[22]

Specify that intellectual property that is the subject of the license agreement is intended to be 'intellectual property' as defined by the Bankruptcy Code. To help address the limitations contained in the Bankruptcy Code and to be afforded the protections of section 365(n), the agreement should make clear that the parties recognize that the intellectual property that is the subject of the license agreement is intended by the parties, and shall be deemed to be, intellectual property under the Bankruptcy Code for purposes of section 365(n) and the agreement. In this regard, the agreement should also make clear that section 365(n) applies to the agreement and the intellectual property, as well as to any sub-licensees of such intellectual property, and that the parties recognize and accept all of the rights and obligations thereunder.

Provide that the failure to perform obligations constitutes a material breach of the agreement. Although most licenses are held to be 'executory contracts' by bankruptcy courts, the license should specifically provide that the licensor's failure to perform obligations constitutes a material breach of the license excusing performance by the licensee. This will help avoid ambiguity as to the 'executory' nature of the agreement and further ensure applicability of section 365(n).

Clearly and narrowly define 'royalty payments'. The license agreement should clearly distinguish between royalty payments (including their amounts) for the use of the intellectual property and fees for continuing affirmative obligations to be performed by the licensor, including maintenance, support and upgrades. This will help reduce the licensee's cost of retaining its rights under section 365(n), and allow for funds to be used to retain alternative service providers. In addition, language should be included that specifically reduces payments to the extent that the licensor's services are reduced for any reason, including the exercise of section 365(n) rights by the licensee.

Specify that the intellectual property is to be delivered following default or rejection. Although section 365(n)(3) requires the turnover by the debtor–licensor of intellectual property to the licensee upon written request, it limits such relief to the terms of the license agreement. Thus, it is critical that this relief be set forth in detail and as broadly drafted as possible, including that such relief be provided upon default or rejection under section 365. This relief, among other things, enables the licensee to find a third party servicer to help maintain the intellectual property or otherwise take over the obligations of the debtor–licensor. It is also prudent to obtain the right to substitute maintenance upon rejection by the debtor–licensor so that the licensee can provide intellectual property to third parties for support functions without violating non-disclosure or exclusivity provisions.

Use a bankruptcy remote entity ('BRE'). Notwithstanding the rights granted under section 365(n), adverse consequences generally result from the debtor–licensor's filing for bankruptcy protection. Thus, to the extent possible, the licensee should request that a

BRE be established to hold the license and intellectual property. From a voluntary bankruptcy perspective, the licensee should insist that it be a controlling stockholder in the BRE with veto power over certain transactions (that is, commencement of any bankruptcy filing). From an involuntary bankruptcy perspective, the BRE should be bound by operational covenants that restrict its ability to incur liabilities. Although no BRE is 'bankruptcy proof', as we have seen from recent bankruptcy cases, these structures may be helpful leverage in negotiations following defaults.

Provide licensee with the right to all improvements and enhancements to intellectual property. Although section 365(n) relieves the debtor–licensor of the post-rejection obligation to provide the licensee with any improvements or developments to the technology, there is nothing in the Bankruptcy Code that prohibits the parties from contractually agreeing to differing terms and conditions, as long as such covenants are supported with fair consideration, including corresponding payment obligations by the licensee. Courts may differ as to the enforceability of such provisions, but the licensee will not find out unless it tries.

Include liquidated damages clause in license agreement. Circumstances may be that filing a claim for rejection damages may be the best alternative for the licensee. In that case, the licensee will need to file a proof of claim setting forth, among other things, the amount of damages. In the case of licenses, such calculations are generally difficult and often subject to litigation. By providing a liquidated damages clause, the parties can remove this level of expense and effort from the overall bankruptcy process.

Include arbitration clause in license agreement. Similarly, inclusion of an arbitration clause can help to reduce the legal costs associated with protecting the licensee's rights in bankruptcy. These clauses are enforced by most bankruptcy courts and almost all courts have established arbitration and mediation protocols.

LICENSOR DRAFTING TIPS

How is the situation different when the licensee files for bankruptcy protection, and what can the licensor do to protect itself? The licensor will have two main concerns: (a) that royalty payments under the license will cease and (b) the debtor–licensee will not fully or properly utilize the intellectual property.

Unlike the licensee, the licensor cannot avail itself of the protections provided by section 365(n). Thus, it must exercise those rights generally available to parties to an executory contract, including seeking to compel the debtor–licensee to assume or reject the license agreement as early in the case as practicable. Although courts are generally reluctant to force such decisions upon debtors at early stages of the bankruptcy, these decisions are fact-based and look to, among other things, the adverse financial positions of the parties, including the extent to which (i) the licensor anticipates incurring large expenses complying with the terms of the license, (ii) the licensee's degraded financial condition impairs its ability to sell the licensed product and (iii) the licensee can assign the license to a competitor or significant customer of the licensor.

In addition to limiting the drafting tips outlined above for the licensee, the licensor can consider the following:[23]

Include provision that narrowly defines 'adequate assurance of future performance' requirements. The license agreement should include a provision that limits the pool of potential assignees of the license by narrowly (or strictly) defining the 'adequate assurance of future performance' requirements under section 365(f)(2). By doing so, the licensor should have more control over selection process for any replacement licensee, or otherwise pressure the debtor–licensee to reject the agreement in a timely manner.

Limit recipients of royalty payments to licensor. The licensor will want to make clear that it is the sole recipient of royalty payments, and in the event of any default by licensee, any payments, including sub-licensee payments, are to be made directly to the licensor. Be careful here and do not make the payment trigger the bankruptcy filing by the licensee. Courts will generally find such conditions to be unenforceable ipso facto clauses.

CONCLUSION

In today's economy, no counterparty is immune from the impact of bankruptcy. However, by understanding the effect of the Bankruptcy Code, including the rights and obligations under section 365(n), as well as taking into account the foregoing drafting techniques, licensors and licensees can better prepare themselves for the unexpected notice of their counterparty's bankruptcy filing.

NOTES

1. *See* 11 U.S.C. §365 (requiring a debtor's compliance under the Bankruptcy Code as prescribed therein).
2. *See* 3 *Collier on Bankruptcy* ¶365.02[2][A] (16th ed. 2010) (providing a general analysis of the term 'executory contracts').
3. 11 U.S.C. §§365(a), (f).
4. *See Stewart Title Guaranty Co.* v. *Old Rep. Nat'l Title Ins. Co.,* 83 F.3d 735, 741 (5th Cir. 1996) (entire contract must be assumed or rejected).
5. 11 U.S.C. §§365(b)(1)(A) – (C).
6. Although 'adequate assurance' is not statutorily defined in the Bankruptcy Code, the term has some flexibility and courts have considered the following non-exclusive factors: debtor's payment history, presence of a guarantee, presence of a security deposit, evidence of profitably, general outlook in debtor's industry, and whether the agreement is at or below the prevailing market rate. *See* 3 *Collier on Bankruptcy* ¶365.06[3][b] (16th ed. 2010).
7. *Stewart Title Guaranty Co.*, 83 F.3d at 741.
8. 11 U.S.C. §365(g).
9. 756 F.2d 1043, 1045 (4th Cir. 1985), *cert. denied*, 475 US 1057 (1986).
10. 11 U.S.C. §§365(n)(1)(A) – (2)(C).
11. 11 U.S.C. §365(n)(1).
12. 11 U.S.C. §§365(n)(1)(A) – (B).
13. 11 U.S.C. §101(35A).
14. *Id*.
15. *See supra* note 12.
16. *See Szombathy* v. *Controlled Shredders, Inc.*, 1997 WL 189314, at *3 (N.D. Ill. 1997).
17. 11 U.S.C. §§365(n)(2)(B) – (C).
18. *In re Prize Frize Inc.*, 150 B.R. 456, 459-60 (9th Cir. B.A.P. Feb. 11, 1993).
19. See In re Szombathy, 1996 WL 417121, at *9 (Bankr. N.D. Ill. 1996), rev'd in part on other grounds, Szombathy v. Controlled Shredders, Inc., 1997 WL 189314 (N.D. Ill. 1997).
20. 11 U.S.C. §365(n)(1)(B).
21. 11 U.S.C. §365(n)(3)(A).
22. Please note that applying the following drafting tips is not a guarantee of success in the event of a bankruptcy filing by a licensor.
23. Similarly, applying the following drafting tips is not a guarantee of success in the event of a bankruptcy filing by a licensee.

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