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**IP in Bankruptcy:
Addressing Licensor and
Licensee Concerns**

**Presentation to the LES
Aerospace & Transportation
Committee**

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IP in Bankruptcy

- Bankruptcy Code sections applicable to IP
 - § 365(a) – assume or reject
 - § 365(c) – ability to assume or reject
 - § 365(e) – ipso facto clauses
 - § 365(n) – licensee protection
 - § 363(f) – asset sale
- Trademarks
- Foreign debtor

Bankruptcy Code Definition of Intellectual Property

(35A) The term “intellectual property” means —

- (A) trade secret;
- (B) invention, process, design or plant protected under title 35;
- (C) patent application;
- (D) plant variety;
- (E) work of authorship protected under title 17; or
- (F) mask work protected under chapter 9 of title 17; to the extent protected by applicable non-bankruptcy law.

Licensee Bankruptcy

- What risk to Licensor?
- How does Licensor protect itself?
 - Payment in advance
 - “Licensor may terminate the Agreement in the event Licensee [files for bankruptcy]”

Licensors Bankruptcy

- What risk to Licensee?
- How does Licensee protect itself?
 - “Software Escrow Release Condition shall include ... Licensor [filing for bankruptcy]”

§365(e) - *Ipsa Facto* Clauses

- No *ipso facto* clauses (§365(e)(1))
- No provision that terminates or modifies contract any time after commencement of bankruptcy conditioned on
 - Insolvency or financial condition of debtor
 - Commencement of bankruptcy
 - Appointment of trustee or custodian

§365(e) - *Ipsa Facto* Clauses

- Exception (i.e., you can have an *ipso facto* clause) (§365(e)(2))
 - If applicable law excuses the non-debtor from performing/accepting performance from another
 - Regardless of whether contract prohibits or restricts (e.g., regardless of non-assignment clause)

§365(e) - *Ipsa Facto* Clauses

- Can you have an *ipso facto* clause in a software license?
 - Non-exclusive IP and software license generally not assignable
 - *Ipsa facto* clauses permitted
 - Exclusive license – courts split, Del. and Ill. bankruptcy courts say assignable
 - *Ipsa facto* clauses might be permitted

§365(a) - Assumption or Rejection

- General rule:
 - Debtor/trustee can assume or reject executory contracts
- Exception:
 - Not if applicable law excuses the non-debtor from performing/accepting performance from another
 - Regardless of whether contract prohibits or restricts

§365(a) – Mechanics

- Requires bankruptcy court approval.
- Chapter 11 reorg
 - IP licenses generally can be assumed or rejected at any time before plan confirmation. See 11 U.S.C. § 365(d)(2).
- Chapter 7 liquidation
 - Decision to assume or reject must be made within 60 days following the petition date unless extended by the court for cause during the 60 day period. See 11 U.S.C. § 365(d)(1).

§365(a) – Mechanics

- Standard for Determining Whether to Assume or Reject
 - Business Judgment Test is generally accepted
 - The effect of rejection on the non-debtor party will still be considered by the court

§365(a) – Assumption or Rejection

- The Bankruptcy Code authorizes the trustee in bankruptcy to assume or reject any executory contract subject to court approval. See 11 U.S.C. § 365(a).
- This policy is grounded in the notion that a debtor should have the ability to abandon burdensome property and retain beneficial property.
- The ability to reject a contract creates tensions in situations where other businesses have licensed technology from the debtor.

§365(a) – Executory Contracts

- The Bankruptcy Code does not define what constitutes an executory contract.
- Courts generally use the “Countryman” Test:
 - An executory contract is “[a] contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other.” Prof. Vern Countryman, Executory Contracts in Bankruptcy.- Part 1, 57 Minn. L. Rev. 439, 460 (1973).

§365(a) – Executory Contracts

- Most IP license agreements are executory
- Obligation to pay royalties may be insufficient
- Examples of on-going Licensor Obligations:
 - (a) covenants not to sue for infringement;
 - (b) duties to maintain the IP;
 - (c) duties to protect against infringement that would impair the licensee's rights.

§365(a) – Executory Contracts

- Examples of on-going Licensee Obligations:
 - (a) covenant to use the IP in a specified manner;
 - (b) reporting obligations.
 - (c) negative covenants (e.g., no reversing engineering, distributing (including territorial restrictions), acting service bureau)

Executory Contract vs. Disguised Sale

- An exclusive license is more likely to be held to be a disguised sale than is a non-exclusive license.
- Exclusive “license” may exhaust the economic life of the property and be a disguised sale. *See Zenith Prods. Ltd v. AEG Acquisition Corp. (In re AEG Acquisition Corp.)*, 127 B.R. 34, 59-60 (Bankr. C.D. Cal. 1991).
- Non-exclusive license may constitute a disguised sale if the economic realities show that the licensor has no continuing material performance obligations. *Microsoft Corp. v. DAK Industries, Inc. (In re DAK Industries, Inc.)*, 66 F.3d 1091, 1095-96 (9th Cir. 1995).

§365(a) – Consequences of Rejection

- Rejection constitutes a breach of the contract immediately before the date of the bankruptcy unless the contract was assumed post-petition and thereafter rejected, in which case the rejection would be treated as a post-petition administrative claim.
- Because the rejection is only deemed a breach, contract provisions still apply
 - amounts due under the contract
 - damages for breach
 - arbitration clauses
 - security interests created by the contract .

§365(c) - The *Catapult* Debate

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

§365(c) - The *Catapult* Debate

- Hypothetical Test (hypothesize debtor will also assign)
 - *In re Catapult Enter., Inc.*, 165 F.3d 747 (9th Cir. 1999)
 - *In re West Elecs., Inc.*, 852 F.2d 79 (3d Cir. 1988)
 - *In re Sunterra Corp.*, 361 F.3d 257 (4th Cir. 2004)
 - *In re James Cable Partners, L.P.*, 27 F.3d 537 (11th Cir. 1994)

- Actual Test (must be evidence debtor may assign)
 - *In re Footstar, Inc.*, 323 B.R. 566 (*Bankr. S.D.N.Y.* 2005)
 - *In re Mirant Corp.*, 440 F.3d 238 (5th Cir. 2006)
 - *Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1997)

§365(n) – Licensee Protection

- Balances the bankruptcy policy of maximizing estate by allowing rejection of burdensome contracts with the IP policy of favoring scientific and technological advancement.
- Prevents the rug from being pulled out from under the licensee
- Deals only with licensor bankruptcy

§365(n) – Licensee Protection

- In the event of rejection the licensee has two options:

Option 1: Treat the rejection as a termination of the license agreement and seek to recover damages for breach of contract. See 11 U.S.C. § 365(n)(1)(A).

§365(n) – Licensee Protection

Option 2: Retain the rights under the license agreement as those rights existed immediately before the bankruptcy case was commenced

- (1) Licensee must make all “royalty” payments for the duration of contract and any period it could have (§365(n)(1)(B)(i)-(ii)); and
- (2) Licensee must waive any right of set-off it may have under the contract and any administrative claims under section 503(b). (§365(n)(2))

§365(n) – Contractual Protections

If Option 2:

- To the extent provided in the contract or an agreement supplementary to the contract, licensee can obtain any intellectual property and embodiment held by the trustee; and
- Trustee can not interfere with the rights of the licensee as provided for in the contract or an agreement supplementary to the contract, including the right to obtain the intellectual property from another entity (escrow).

§365(n) – Contractual Protections

Section 365(n)(4) requires the trustee to:

- Perform
- Provide the physical embodiment to the licensee if the contract provides for that right
- Not interfere with the right to obtain the physical embodiment from a third party if the contract provides for that right

§365(n) – Drafting Considerations

- “All rights and licenses granted pursuant to any section of this Agreement, including without limitation, all rights and licenses to use improvements or enhancements developed during the term of this Agreement, are intended to be, and shall be deemed to be, for purposes of § 365(n) of the Bankruptcy Code, licenses of rights to “intellectual property” as defined under § 101(35A) of the Bankruptcy Code.”
- “This Agreement shall be deemed a license of IP, and the Software Escrow Agreement shall be deemed an agreement supplementary thereto, within the meaning of §365(n).”

§365(n) – Drafting Considerations

- “In the event that this Agreement is rejected or deemed rejected in a bankruptcy proceeding (a “Rejection”), the Licensor shall provide written notice thereof to the Licensee. In the event that the Licensee makes no election under § 365(n) of the Bankruptcy Code within sixty (60) days following written notice of such Rejection to either treat the contract as terminated, or to retain its rights, the Licensee shall be deemed to have made a formal election to ...”
- “Licensor hereby sells to Licensee the Master Copy of the Licensed Software”

§365(n) – Drafting Considerations

- “Licensor hereby grants Licensee the right to Use the Source Code ... Provided Licensee agrees not to exercise such rights until ...”
- “Licensor hereby grants Licensee a security interest in the Licensed IP”

§363(f) - Sale “Free and Clear”

A sale can be made “free and clear” pursuant to § 363(f) if:

- (1) Applicable non-bankruptcy law would permit the sale of the property free and clear of such interest;
- (2) The interested entity “consents” to the sale;
- (3) The interest is a lien and the price at which the property is to be sold is greater than the aggregate value of all liens on the property;
- (4) The interest is in bona fide dispute; or
- (5) The entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

Does §365(n) Apply to 363(f) Sales?

- A number of bankruptcy courts have suggested that the protections of 365(n) *do extend* to 363(f) sales
- Other decisions suggest 365(n) *does not* apply

Does §365(n) Apply to 363(f) Sales?

NO if Implied Consent

- *Future-Source L.L.C. v. Reuters, Ltd.*, 312 F.3d 281 (7th Cir. 2002)

Licensee of intellectual property could “**implicitly consent**” to the sale of its interest “free and clear” **simply by failing to object to the sale** - provided, of course, that it had “notice” of the sale.

- *In re GSC, Inc.*, 453 B.R. 132, 183 (Bankr. S.D.N.Y. 2011)

Does §365(n) Apply to 363(f) Sales?

NO by analogy

- *Precision Industries, Inc. v. Qualitech Steel Corp.*, 327 F.3d 537 (7th Cir. 2003)
 - 365(h) is designed to protect real property lessees in the same way 365(n) protects IP licensees.
 - 365(h) protections not applicable to 363(f) sales

Does §365(n) Apply to Trademarks?

- Trademarks excluded from definition of IP
 - Exclusion of trademarks from Bankruptcy Code definition of “intellectual property” appears to have been deliberate
 - Unlike owners of copyrights and patents, trademark owners must take affirmative acts to control use
- But courts have provided similar protections under equitable theories

Does §365(n) Apply to Trademarks?

- *Yes: In re Matusalem*, 158 B.R. 514 (Bankr. S.D. Fla. 1993)
- Court's equitable powers: *In re Exide Techs.*, 607 F.3d 957 (3rd Or. 2010)
- No: Nearly every other case

Foreign Debtor

- Does Section 365(n) apply to the rejection of U.S. patent licenses by a foreign debtor?
- *In re Qimonda AG*, 2011 WL 5149831 (Bankr. E.D. Va. 2011)
 - German bankruptcy case with a U.S. “foreign representative” (Chapter 15)
 - It would be “manifestly contrary to the public policy of the United States” not to give U.S. patent licensees the protection of 365(n)

Licensee Bankruptcy - Rejection

- When debtor-licensee rejects a license, treated as breach and licensor gets an unsecured claim for damages from deemed breach
- Licensor entitled to administrative expense claim for use of license prior to debtor-licensee rejection
- Licensor may (try to) compel debtor-licensee to assume or reject

Licensee Bankruptcy - Assumption

- Debtor-licensee/trustee must cure existing defaults other than defaults relating to financial condition/bankruptcy
- Debtor-licensee/trustee must provide adequate assurances that it (or its assignee) will perform

Licensee Bankruptcy - Assumption

- When debtor-licensee assumes license, it retains rights but
 - must assume entire agreement
 - must comply with on-going obligations
 - Subsequent breach gives rise to administrative expense claim
- Debtor-licensee/trustee must provide adequate assurances that it (or its assignee) will perform

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