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# IP CONTRACT ISSUES IN BANKRUPTCY ASSET SALES

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## IP Contract Issues in Bankruptcy Asset Sales

The tech implosion has created a fertile market for buyers of IP assets at distressed prices. Just a few recent examples indicate the type of deals getting done during this past year:

- Northern Light
  The former CEO of Northern Light paid $81,000 in a bankruptcy auction to acquire the search engine's assets – assets that Chicago-based software and services conglomerate Divine Inc. had purchased for a reported $16 million about a year earlier.
- Engage
  JDA Software acquired substantially all of the assets of Engage, a provider of enterprise advertising, marketing and promotion software solutions for $3 million in cash and assumed liabilities of $800,000. Engage had been a prototypical boom highflier: After its CEO rang the bell to open NASDAQ's trading on July 21, 1999, Engage's stock realized a 173 percent opening day gain from $15 to $41.
- Genuity
  Wholesale communications provider Level 3 Communications -- backed by Warren Buffet's Berkshire Hathaway -- acquired substantially all assets of bankrupt rival Genuity out of Chapter 11 for a reported purchase price of $137 million cash.

In many respects intellectual property asset sales involve the same issues as non-intellectual property asset sales. Thus, break-up fees, bidding protections, and strategies to avoid successor liability, etc all apply. Yet, by their very nature, IP assets have unique characteristics that distinguish them from other types of assets routinely sold out of bankruptcy.

This paper focuses on the contracts that typically are the source of IP rights and ways for various parties affected by an IP asset sale to protect their interest with respect to a proposed sale. Specifically,

- Non-debtor **licensors** must be aware of the rights of a debtor licensee to assume and assign contracts and the strategies available to licensors to protect their interests.
- Non-debtor **licensees** must also be aware of their rights in the event a debtor licensor attempts to sell off the licensor's rights.
- **Potential buyers**, in conducting due diligence, need to scrutinize carefully the debtor's IP contracts to be sure the buyer can acquire what it desires.
- **Debtors** need to be able to deliver the assets -- specifically the contractual rights -- that the buyer is interested in.

Part One below sets forth an executive summary of the applicable rules governing treatment of attempted sales of IP contracts out of bankruptcy. Experienced bankruptcy practitioners can proceed directly to Part Two, which sets forth strategies for non-debtor licensees, non-debtor licensors, and buyers to employ.

## PART I. IP Contracts in Bankruptcy Asset Sales -- Overview

The Bankruptcy Code ("Code") contains special provisions regarding executory contracts. Although there is no definition of an executory contract in the Code, it is generally regarded as a contract on which performance is due to some extent on both sides. A contract that has been terminated or that has expired before the commencement of a bankruptcy case is not executory. The Code nullifies any provision in a contract that allows a nondebtor to terminate the contract on the grounds of the insolvency or bankruptcy filing of the debtor.

Under section 365 of the Code and with court approval, a debtor may: (i) reject an executory contract; (ii) assume an executory contract; or (iii) in a Chapter 11 proceeding, if the debtor neither rejects nor assumes a contract, let the contract "ride through" the reorganization and leave the rights of the parties thereunder unchanged upon the emergence of the debtor from Chapter 11. With limited exceptions and subject to certain requirements, the debtor may assume any executory contract even though the debtor is, at the time, in default under such contract. Upon assumption, the agreement is in full force and effect and binding on the debtor as well as on the non-debtor; a debtor who assumes a contract receives not only the benefits of the contract, but also must undertake any burden or obligations under the contract.

Alternatively, the debtor may reject the agreement rendering it prospectively unenforceable; a debtor cannot reject a contract and still assert rights under provisions of the agreement. Rejection of an agreement constitutes a breach, which is deemed to occur just prior to the bankruptcy filing and entitles the non-debtor to assert a pre-petition claim for damages against the estate; such claim is treated as a general unsecured claim.

A debtor does not need to decide to assume or reject an executory contract immediately. In Chapter 7 liquidation cases, a contract is deemed rejected unless it is assumed within sixty days after the order for relief is entered or within such additional time as the court permits. In Chapter 11 reorganization proceedings, the debtor has until confirmation of the plan of reorganization to assume or reject executory contracts. If the non-debtor insists, the bankruptcy court may, under appropriate circumstances, require the debtor to decide within a shorter period whether to assume or reject.

### 1. Obtaining Rights under Desirable Contracts of the Debtor; Avoiding Liabilities under Nondesirable Contracts

#### (a) Assumption

The Code provides no specific statutory requirements for assuming a contract where the debtor is not in default, other than the requirement of court approval. Where there is a default, however, the debtor must provide the non-debtor with adequate assurance that it will (i) promptly cure the default; (ii) promptly compensate the non-debtor for any actual pecuniary loss resulting from the default; and (iii) perform its future obligations to the non-debtor under the contract. The adequacy of these assurances is governed by the standard of commercial reasonableness, and thus the debtor does not have to make a showing of absolute certainty that its performance will always be satisfactory to the non-debtor.

### (i) Curing the Default

The debtor may cure defaults under an executory contract by rendering all performances then due under the contract. There are certain defaults, however, that the debtor need not cure for it to assume the contract. Defaults arising from a breach of a contractual provision relating to the commencement of a bankruptcy case, the appointment of a bankruptcy trustee or the insolvency or financial condition of the debtor at any time prior to the closing of the case need not be cured for the debtor to assume the contract or release. Although the Code does not specify the types of contract provisions which relate to the "financial condition" of the debtor, essentially default provisions based on a debtor's profits or revenues are likely to be considered provisions related to the debtor's financial condition. Contract provisions creating defaults solely because of the debtor's insolvency are unenforceable under the Code. Often, the financial circumstances leading to bankruptcy preclude the debtor from being able to cure defaults by rendering performance. Consequently, the debtor may defer its cure but must provide adequate assurance of its future ability to effect the cure. The Code contains no standards for determining what constitutes adequate assurance of prompt cure, and therefore a "prompt cure" will depend on the circumstances of each case.

### (ii) Compensate for Actual Pecuniary Loss

The debtor must also provide adequate assurance that it will compensate the non-debtor for any actual pecuniary loss resulting from defaults under the contract in order to assume that contract. Generally, the case law suggests that the debtor's cure of defaults in most instances moot any claim for actual pecuniary loss.

### (iii) Adequate Assurance of Future Performance

Finally, in order to assume a contract the debtor must provide adequate assurance of future performance thereunder. A court's determination of whether a debtor has complied with this requirement may be based upon, among other things, whether the debtor's financial data indicates its ability to generate an income stream sufficient to meet its obligations, the general economic outlook in the debtor's industry, and the presence of a third party guaranty. The words "adequate assurance" are to be given a practical construction and a determination of what constitutes adequate assurance of future performance is determined under the facts of each particular case.

### (b) Rejection

Instead of assuming an executory contract, a debtor can reject the contract. No standard for rejection is expressly set forth in the Code; the "business judgment" test is applied. If a contract is rejected, the non-debtor will be left with a claim for damages. This rejection claim is treated as a pre-petition claim. Damages arising from rejection of leases and employment contracts are limited by the Code; in all other cases, actual damages may be claimed. Licenses

under a rejected intellectual property are afforded special treatment (discussed below).

### (c) Assignment

Under the Code, the debtor has the authority to assume and then assign an executory contract. Generally, anti-assignment clauses in executory contracts are not enforceable. Except as discussed below, the debtor is free to assign a contract if it cures prior defaults and compensates the non-debtor for pecuniary losses, and the assignee provides adequate assurance of future performance under the contract. Upon assignment, the debtor has no further obligation under the agreement.

### (d) Executory Contracts in Limbo

Until an executory contract is assumed or rejected, it is not enforceable against the debtor. The debtor may, however, elect to receive benefits under the agreement and require the non-debtor to perform contracts that are otherwise in limbo pending assumption or rejection. During this limbo period, the non-debtor is entitled to payment for the value of its performance to the debtor, and such claims for payment are entitled to administrative priority status (that is, such claims must be paid in full prior to any payment of prepetition unsecured claims).

The non-debtor can take several steps to ameliorate any adverse effects which might result during the period the contract is in limbo pending the debtor's decision to assume or reject. It can request that the court order the debtor to assume or reject the agreement within a specified time period. The general rule, however, is that the debtor should have a reasonable time in which to make its decision regarding assumption or rejection. Also, the nondebtor may ask the court to order the debtor to comply with parts of the agreement, the noncompliance of which would unfairly prejudice the nondebtor party.

## 2. Restrictions on Assumption and Assignment

The general rules regarding assumption and assignment are subject to one provision that has had significant importance to the determination of IP rights in bankruptcy. Specifically, Section 365(c)(1) of the Code recognizes that certain types of contracts should not be subject to assumption and assignment over a licensor's objection when applicable nonbankruptcy law excuses the nondebtor from accepting performance. The classic example of a contract that is not subject to assumption and assignment is a personal services contract. State law allows a nondebtor to refuse acceptance of performance from anybody other than the original contracting party -- and the Code honors that result. Litigation has occurred over what other type of law excuses acceptance of performance. The law seems well settled that a non-exclusive patent or copyright license agreement may not be assigned by the debtor licensee without the consent of the licensor unless the license itself permits such assignment. See Everex Systems, Inc. v. Cedtrak Corp., 89 F3d 673 (9th Cir. 1996); In re Education Media, Inc., 210 B.R. 237 (Bankr. S.D.N.Y. 1997).

Section 365(c)(1) has been used successfully by some licensors to prevent not only

assignment of their IP licenses, but to also prevent mere assumption by the debtor. Two circuit courts of appeal and the Bankruptcy Court for Delaware have concluded that a debtor that has no ability to assign an IP contract also lacks the ability to assume such a contract. These decisions (see e.g. In re Catapult Entertainment, Inc., 165 F.3d 747 (9th Cir. 1999), cert dismissed, 528 US 924 (1999) place incredible leverage in the hands of licensors by allowing them to seek to obtain control of the license once a licensee files. Other courts have rejected that approach and instead allow a debtor to assume an IP license if it has no actual intent to assign but instead will continue to perform itself. See Institute Pasteur v. Cambridge Biotech Corp., 104 F.3d 489 (1st Cir. 1997), cert. denied, 521 U.S. 1120 (1997).

### 3. Special Rules for Licensor Bankruptcy Cases

The application of the general rules of Section 365 had devastating consequences to an IP licensee in Lubrizol Enterprises v. Richmond Metal Finishers, 756 F.2d 1043 (4th Cir. 1985), cert. denied, 106 S.Ct. 1284 (1986). In that case, the debtor owned a unique metal coating process. Pre-petition, it granted a non-exclusive license to Lubrizol Enterprises to use the process. One year after entering into the license agreement, the debtor filed for bankruptcy protection and sought to reject the license agreement. The Fourth Circuit concluded that the license agreement was executory as to both parties and could be rejected by the debtor. The rejection stripped Lubrizol of all of its rights to the licensed technology and left it with a claim for damages against the estate in accordance with the general rules set forth above. In the concluding paragraph of its opinion, the Fourth Circuit noted that its decision would impose a serious burden on Lubrizol and could have a chilling effect upon the willingness of parties to enter into licensing agreements with businesses in possible financial difficulty. Nevertheless, the Fourth Circuit thought that it was up to Congress, not the judiciary to remedy the situation.

In true democratic fashion, Lubrizol and other licensees appealed to Congress to remedy the situation. In response, Congress passed the Intellectual Property Bankruptcy Protection Act in 1988, which added a definition of "Intellectual Property" to Section 101 of the Bankruptcy Code and also a new section (n) to Section 365 governing executory contracts. "Intellectual property" is defined to mean the following:

> (A) trade secret;
> (B) invention, process, design, or plant protected under Title 35 [The Patent Act];
> (C) patent application;
> (D) plant variety;
> (E) work of authorship protected under Title 17 [The Copyright Act]; or
> (F) mask work protected under Chapter 9 of Title 17; to the extent protected by applicable nonbankruptcy law.

11 U.S.C. § 101(35A).

Section 365(n) provides two options for a licensee under an IP license in the event that the licensor files for bankruptcy and rejects the license in its bankruptcy case. First, the licensee may treat the license as terminated and file a general unsecured claim against the bankruptcy

estate for breach of contract damages, in which case it will forfeit all rights to continued use of the intellectual property relating to the license.

Alternatively, the licensee may opt to retain its rights under the license to the technology, including rights of exclusivity, and under any agreement supplementary to the license. The licensee may retain these rights for the initial term of the contract as well as for any optional extension periods available at the licensee's discretion, but must continue to pay all royalties due the licensor. The licensee is deemed to waive any rights of setoff it might have against the licensor as well as any administrative claims against the estate that it might have. Rejection relieves the debtor licensor of any burdens to take on any additional affirmative action pursuant to the license, such as training of licensee users or updating the intellectual property.

Two limitations on the scope of Section 365(n) must be emphasized: (1) the definition of "intellectual property" does not include trade marks and trade names and (2) the section does not address what happens when a licensee files for bankruptcy protection. In the latter case, the general rules concerning rejection, assumption and assignment will apply.

## PART II. ip sale strategies

### 1. Strategies for Licensor Pre-Bankruptcy and Upon a Debtor/Licensee's Attempt to Assume and Assign the License to a Buyer

When a licensor learns that a licensee has commenced bankruptcy proceedings with the purpose of selling substantially all of its assets, the licensor should immediately take action to protect its intellectual property rights. As noted below, the best time for a licensor to act is not after a filing but well before it -- during the happy, solvent days of negotiation and drafting the applicable license.

Licensors should consider the following when drafting a license to minimize the chance for an undesired assignment:

- Ensure that the license is executory. If the licensee has no continuing obligations under the license, the license may be deemed to be a transfer of an asset and not a license. Have the parties acknowledge their intent that the license be considered executory and state the applicable reasons supporting the position. Ongoing obligations such as maintenance of confidentiality, reporting, etc. will prevent the licensee from claiming an outright ownership right - especially in an exclusive license. If an exclusive license must be granted, obtain a security interest in the licensee's interest.

- Prohibit or limit assignment. As noted above, the Bankruptcy Code prohibits enforcement of most anti-assignment clauses. Yet such clauses in copyright licenses can be enforced by the non-debtor licensor. When drafting the license, a careful licensor will prohibit assignment or limit it to very specific conditions to demonstrate why a particular licensee was approved to receive the license. Include a provision that upon an acquisition or change in control, the license is

automatically terminated.

- Expand termination rights. As with anti-assignment clauses, the right to terminate on account of a bankruptcy filing (an "ipso facto" clause) is also generally held to be unenforceable. Licensors should enhance termination clauses to include other measures of impending financial difficulty such as the departure of key executives, or the licensee's failure to meet certain milestones.

- Limit term. A licensee is only able to assume and assign those contracts in effect as of the petition date. Annual automatic renewal clauses, unless notice of non-renewal has been given, are one way to limit term.

Once a filing occurs, the licensor, of course, is bound to whatever contractual terms may then exist. A licensor faced with a debtor/licensee's motion to sell assets will want to know the following:

- Who is the stalking horse bidder for the assets and who are the likely counterbidders?
- Does the stalking horse or other bidder desire to obtain an assignment of the licensor's contract with the debtor/licensee? Should the licensor seek to block any attempted assignment by virtue of the enforceability under "applicable non-bankruptcy law" of an anti-assignment clause in the contract?
- What cure amount, if any, does the debtor/licensee contend is owing on account of the agreement in place?
- Does the licensor have the opportunity to sell directly to the proposed assignee and, thus, will the assignment deprive it of potential new revenue for its own account?
- What will the impact be on maintenance revenue going forward?
- The licensor should also be sure that any postpetition/pre-assignment provision of maintenance service is allowed as and paid as an administrative expense claim.

## 2. Strategies for Licensee Pre-Bankruptcy and Upon a Debtor/Licensor's Attempt to Assume and Assign the License to a Buyer

During the negotiation of a technology license, a licensee can take certain steps to maximize the potential benefits of section 365(n).

- Split-up payments. The total amount paid by the licensee to the licensor should be split up in the license agreement. The license agreement shall allocate one payment obligation to fees for rights the licensee can retain under section 365(n), such as running royalties, and can allocate other payment obligations to fees for rights the licensee may not necessarily retain, such as maintenance and support fees. By specifying the payments separately, the licensee can avoid paying for performance that the licensor may elect not to provide upon rejection.

- Supplemental agreements must be executory. The Licensee should insist that supplemental agreements include maintenance and support agreements and source code escrow agreements. Maintenance and support agreements are executory if they require future services from the licensor in exchange for payments by the licensee. A source code escrow agreement can be made executory by requiring the licensor to deposit the source code and documentation for all updates and enhancements of the licensed technology.

- Source code escrow agreements are essential. If source code is not licensed under a software license agreement, a licensee should enter into source code escrow arrangements, under which the licensor deposits source code and documentation with a third party. Escrow agreements should be carefully crafted to provide the appropriate "triggers" for release of the deposited materials and rights to the licensee with regard to use of such materials. Source code escrow agreements should expressly give the licensee the right to receive the escrowed materials upon the insolvency or filing for bankruptcy protection of the licensor for example. They should also provide the licensee with the right to use the materials to modify and maintain the licensed technology and to use the licensed technology to provide support to sublicensees and internal users. This distinct grant in the source code escrow agreement must be carefully drafted so it is a present grant to use the escrowed material, and not just a license right becoming effective upon bankruptcy.

Once a filing occurs, the non-debtor licensee should consider the following:

- Does the debtor/licensor intend to reject the license? Move aggressively to ensure licensee obtains all rights under 365(n) if the licensee elects to retain the licensed rights under a rejected license.

- Does the debtor/licensor intend to assume and assign the license? Does the licensee have any basis for a cure claim? Can the proposed buyer provide adequate assurance of future performance?

- Does a basis exist to access the escrowed source code?

### 3. Issues of Concern for a Buyer of IP Assets

As noted earlier, a buyer interested in acquiring IP assets out of bankruptcy faces the same issues that a buyer of any other type of asset from bankruptcy. There are several considerations that an IP buyer needs to be particularly aware of:

- Is there benefit to the buyer in incurring the cost of serving as the stalking horse or should the buyer instead act as a counterbidder?

Issues:

- diligence comfort level

- need for employees

- What confidentiality concerns exist?
  - employee salaries
  - customer list

- What IP contracts are needed?

- For contracts under which debtor is licensor
  - if contract will be rejected, consider which licenses will likely invoke 365(n) election rights and any impact such licensee's retention of software have on buyer's future operations.
  - if contract will be assumed, are any cure payments necessary? Negotiate the allocation of responsibility for payment with the debtor.

- For contracts under which debtor is licensee
  - if contract will be assumed, will licensor object?
  - What is remedy for debtor's inability to deliver designated contracts? (purchase price adjustment)
  - What is the cure amount? Does licensee agree? Who will pay?

- Have any claims of infringement been made against the seller in the past? Will the sale approval order provide that the sale will be made free and clear of any claim or interest of any party claiming infringement? Will such an order be enforceable?

**Summary**

Assets sales in bankruptcy involving intellectual property present all the typical issues of any asset sale (bidding protections, auction procedure, successor liability concerns, etc.) plus some unique concerns. Parties to the sale need to understand the nuances of 11 U.S.C. § 365. In particular, parties need to understand the circumstances under which a court can compel assumption and assignment of those contracts covering critical intellectual property. Nondebtor licensors will often want to prevent a debtor licensee from auctioning off its licensed rights; nondebtor licensees will want to ensure that a new buyer will be able to perform and that its cure costs will be paid promptly. A buyer needs to understand the rights that the debtor seller is able to convey to ensure it is acquiring exactly what it desires at the price it desires.