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What to do if your licensee is headed for bankruptcy

BY JOHN G. LOUGHNANE

Is your company prepared to act in the event of a financial meltdown by a key licensee?

Licensors should protect themselves in two ways. Well ahead of any licensee bankruptcy filing, a licensor should ensure that the license agreement is drafted to provide maximum protection. And if and when a bankruptcy occurs, the licensor should take immediate action.

Licensors should consider the following when drafting a license:

• **Ensure that the license arrangement will be construed as an executory contract.** This is one in which performance remains due on both sides. If the licensee has no continuing obligation under the license, a bankruptcy court may conclude that the document created an absolute transfer of rights as opposed to a mere license of rights.

The license should contain an acknowledgement of the parties' intent that the license be considered executory and should state the reasons why. Ongoing obligations such as maintenance of confidentiality and reporting will help 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.


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• **Prohibit or limit assignment by the licensee to third parties.** The Bankruptcy Code prohibits enforcement by the non-debtor of most so-called anti-assignment clauses in contracts. Yet these clauses in software licenses can be enforced by the non-debtor licensor.

When drafting the license, prohibit assignment or limit it to specific conditions to demonstrate why a particular licensee was approved to receive the license. Include also a provision that upon an acquisition or change in control, the license is automatically terminated.

• **Expand termination rights.** The right to terminate on account of a bankruptcy filing is also generally unenforceable in bankruptcy. 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 able to assume and assign only those executory 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 bankruptcy filing occurs, the licensor is bound to whichever contractual terms may then exist. A debtor usually has the authority to assume for itself, or assume and then assign to a third party, any executory contract.

Generally, a 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. On assignment, the debtor has no further obligation under the agreement. On assumption, the agreement is in full force and effect and is binding on the debtor as well as on the non-debtor.

The general rules regarding assumption and assignment are subject to a provision that is of importance to licensors. When applicable non-bankruptcy law excuses a party from accepting performance from a third party, bankruptcy law honors that result. Courts have determined that a debtor may not assign to a third party licensed property of a non-exclusive patent or copyright licensor over the licensor's objection when the agreement requires the licensor's consent.

In some jurisdictions, licensors have prevented not only a debtor licensee's assignment of the license to a third party, but also mere assumption of the license by the debtor licensee. The majority of the circuit courts of appeal that have considered the issue and the Bankruptcy Court for Delaware have concluded that a debtor that has no ability to assign a contract also lacks the ability to assume such a contract for its own use.

These decisions place leverage in the hands of licensors by allowing them to obtain control of the license once a licensee files. Although the first circuit, which includes Massachusetts, has rejected that approach, the trend is to empower licensors to object to a debtor licensee's attempt to assume a license agreement.

Licenses should be drafted wisely, with assertion of rights in order to obtain the protection that the law provides when a licensee files for bankruptcy.

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So, Your Licensee Has Filed for Bankruptcy - Are you Prepared?

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Is your firm prepared in the event of a meltdown by a key licensee? This article discusses methods for you as licensor to be prepared. First, a brief introduction to Chapter 7 and Chapter 11 of the Bankruptcy Code is in order -- these chapters are a common forum for meltdowns to occur. Then, a short summary of the treatment of contracts, including IP licenses, in bankruptcy is needed.

A. Types of Proceedings; Automatic Stay

Business bankruptcies can be commenced under either Chapter 7 or Chapter 11 of the United States Bankruptcy Code. Bankruptcy cases are commenced in United States Bankruptcy Courts located in each federal judicial district. A financially distressed business may avail itself of state insolvency procedures such as receivership or an assignment for the benefit of creditors, but an understanding of the federal bankruptcy laws is the proper place to begin for the basics.

1. Chapter 7

A bankruptcy proceeding under Chapter 7 is a liquidation case. A Chapter 7 trustee is appointed who has the duty to collect and liquidate the assets of the estate and to distribute the proceeds of the liquidation to creditors. In a typical Chapter 7 case, the debtor files a petition in which it lists all of its assets and all of its debts and a statement of affairs and other schedules disclosing background and budgetary information. An interim trustee is appointed by the United States Trustee and notice is given to creditors of the bankruptcy filing and the first meeting of creditors. Unless a different trustee is elected, the interim trustee normally becomes the trustee in the Chapter 7 case. The trustee takes possession of non-exempt assets, liquidates those assets and distributes the available funds to the creditors in the order of priority set forth in the Bankruptcy Code.

2. Chapter 11

Chapter 11 is the principal reorganization chapter of the Bankruptcy Code and may be used by most entities, including partnerships, corporations and individuals. Normally, the debtor remains in possession of its assets in a Chapter 11 case and no trustee is appointed. Trustees are normally only appointed in a Chapter 11 case if the debtor exhibits dishonesty or gross incompetence. The ultimate objective of a debtor in a Chapter 11 reorganization case is to obtain court approval of a plan of reorganization which restructures prepetition debt. In the process of obtaining plan approval from creditors and the court, the debtor may ask creditors to grant more favorable repayment terms than existed prebankruptcy. If a creditor is unwilling to grant concessions to the debtor, the debtor may be able to force a creditor or a group of creditors to grant certain concessions through the "cramdown" provisions of the Bankruptcy Code.

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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 or leases, other than leases of non-residential real estate, which are subject to a sixty day limit subject to extension for cause. 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.

2. Intellectual Property Licenses

a. Special Rules for Licensor Bankruptcy Cases

The application of the above general rules 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 contracts 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 ("IPBPA") in 1988. The Act 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. 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 the IPBPA must be emphasized: (1) the definition of "intellectual property" does not include trade marks and trade names and (2) it 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.

b. 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 patent license agreement may not be assigned without the consent of the licensor. There is less certainty concerning whether copyright and trademark law excuses a licensor from accepting performance from a third party. One copyright case borrows from patent law and states that a licensor may refuse performance; one trademark case found that the particular trademark license at issue had significant protections for the licensee and allowed the agreement to be assigned.

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. Most circuit courts of appeal that have considered the issue 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 place incredible leverage in the hands of licensors by allowing them to seek to obtain control of the license once a licensee files. The First Circuit Court of Appeals (based in Boston) has rejected that holding 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.

C. Licensor Drafting Tips

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.

Summary

Licensors of intellectual property need to understand the impact of a potential bankruptcy by its licensee. Obviously, a licensor will be concerned about the economic impact of such an event -- but the licensor will also want to guard against an undesired assignment by the licensee to a third party. As noted above, the licensor should protect itself well ahead of any bankruptcy filing by including relevant language in the actual license agreement. If and when a licensee bankruptcy occurs, the licensor will want to take proactive steps in the bankruptcy case to understand how the license is proposed to be treated and to ensure its rights as licensor are protected. A bankruptcy case is no time to sit back and hope for the best -- licensors need to appear and be heard to ensure their rights are not run over in the interest of the licensee and its other creditors.