Business Reorganization and Bankruptcy

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Many insolvency matters in the United States are disposed of without any Bankruptcy Court proceedings at all. Bank foreclosures, voluntary liquidations, and state court receiverships frequently suffice to terminate an ailing company's woes. This presentation focuses on the formal bankruptcy filings that your client's customers, vendors, licensors, licensees, lessors and lessees may make. Most bankruptcy cases filed end up as liquidations, and many of those are "no asset" or "no dividend" cases, in which general creditors receive no payment on their claims. The better informed you are concerning these matters, the better you can help protect your client's interests. The material is organized as follows:

Part I - Overview of Chapter 7 and Chapter 11 basics;

Part II - Asset acquisitions in bankruptcy;

Part Ill - Treatment of IP contracts in bankruptcy; and

Part IV - Overview of claims and payment issues.

PART I - OVERVIEW

Business bankruptcies can be commenced under either Chapter 7 or Chapter 11 of the United States Bankruptcy Code (11 U.S.C. § 101 et seq.). Bankruptcy cases are commenced in United States Bankruptcy Courts located in each federal judicial district.

A. 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 its 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 of the first meeting of creditors (the "Section 341" meeting -- so named for the relevant Bankruptcy Code provision) and of the deadline for filing adversary proceedings concerning the dischargeability of some or all of the debtor's debts.

Creditors, the interim trustee and other parties-in-interest are given the opportunity to examine the debtor under oath about its financial affairs and assets at the Section 341 meeting. Unless a different trustee is elected at that meeting, 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.

B. Chapter 11

Chapter ills 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.

1. Debtor's Exclusivity Right

The debtor has an exclusive right to file a plan of reorganization during the first 120 days of a bankruptcy case. The Bankruptcy Court, however, may extend or reduce the 120-day period upon timely request. Once the debtor's exclusivity period expires, any creditor or other party-in-interest may file a plan of reorganization. The plan of reorganization is essentially a contract between the debtor and its creditors which provides for the treatment of their claims.

2. Plan Voting

Once a plan has been filed, and before votes of creditors can be solicited, a disclosure statement approved by the Bankruptcy Court must be provided to all holders of claims or interests in the debtor's estate. The disclosure statement must set forth the terms of the plan, as well as sufficient information to allow the holders of claims and interests to make an informed decision as to whether to vote for or against the plan. Creditors whose rights are adjusted by the plan of reorganization are eligible to vote in connection with the plan. In order for a class of claims to accept the plan, votes representing at least two-thirds an amount of the claims voted, and more than one-half in number of the creditors actually voting in that class must be cast for acceptance of the plan. Acceptance by a class of interest (equity holders) requires an affirmative vote by two-thirds in amount of the allowed interest actually voting in connection with the plan.

3. Plan Confirmation

Once a plan has been proposed, there are two methods by which it can be confirmed. The "acceptance" methods requires that all impaired classes of claims or interests have voted in the requisite number an amount to accept the plan. The "cramdown" method requires at least one class of impaired claims (but not interests) to have voted in the requisite number an amount to accept the plan and requires the plan to meet certain other requirements set forth in Section 1129(b) of the Bankruptcy Code. In either event, the Bankruptcy Code requires that each creditors must be paid at least as much as it would have received in a Chapter 7 liquidation case in addition to full payment of priority claims.

C. Parties to Chapter 11 Case

1. The Debtor

The debtor is the entity that commences a case or has a case commenced against it. In Chapter 11 there is a strong presumption that the debtor should retain control of its business

during reorganization, subject to some degree of supervision by one or more committees and by the United States Trustee. In that capacity, the debtor is characterized as a "debtor in possession" and remains in possession unless a specific showing is made justifying appointment of a trustee. As a debtor in possession, the debtor is a fiduciary and is responsible for protecting, collecting and conserving the bankruptcy estate's property for the benefit of creditors.

The debtor in possession generally has all the rights and powers and must perform all the functions and duties of a chapter 11 trustee. It may operate its business without specific court authorization, except that actions outside the ordinary course of business, for example a major asset sale, require court approval. The debtor in possession may prosecute or appear in and defend pending actions or proceedings on behalf of the estate.

In most chapter 11 cases, the debtor in possession is the central focus of the case and is expected to conduct normal business operations, protect the rights of the bankruptcy estate, and take the lead in proposing and negotiating a plan of reorganization. Once a trustee is appointed the role of the debtor in the case essentially ends.

2. Committees

As soon as practicable after the order for relief is entered, the United States Trustee is directed by statute to appoint a committee of creditors holding unsecured claims. In addition, the United States Trustee may appoint additional committees of creditors or of equity security holders. On request of a party in interest, the Bankruptcy Court may order the appointment of additional committees "if necessary to assure adequate representation of creditors or of equity security holders."

In large bankruptcy cases, there may be several committees representing different interest groups such as trade creditors, equity security holders, debenture holders or preferred stockholders. Committee work can be time consuming and members are not entitled to compensation (although they are entitled to reimbursement of certain expenses). Thus, in cases involving assets of little value to unsecured creditors, a committee is not always appointed because few, if any, creditors are willing to serve.

The Bankruptcy Code specifies that a committee may:

a. Consult with the trustee or debtor in possession concerning the administration of the case;

b. Investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operations of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan;

c. Participate in the formulation of a plan, and advise those represented by such committee of such committee's recommendations as to any plan formulated;

d. Request the appointment of a trustee or examiner; and

e. Perform such other services as are in the interest of those represented.

3. Trustee and Examiner

Although chapter 11 contemplates retention of control by the debtor of its business operation, the Court may appoint a trustee in reorganization. A trustee can be appointed at any time after the filing of the petition and before confirmation of a plan, on request of a party, upon the following conditions: (1) for cause, including fraud, dishonesty, or gross mismanagement, or (2) if such appointment is in the interests of creditors, equity security holders and other interests of the estate. Upon request, creditors have the right to meet and vote for the election of the trustee after the Court has determined that one should be appointed. The appointment of a trustee is considered an extraordinary remedy.

Upon the appointment, the trustee replaces the debtor in possession, and it is authorized to operate the debtor's business. An operating trustee has, among his powers, the right to replace management personnel of the debtor. The trustee also has the duty to investigate the debtor's affairs, to file a report of his investigation, and to file a plan or a report setting forth why he is unable to file a plan.

If no trustee is appointed, at any time before confirmation of a plan, on request of a party in interest, the court may appoint an examiner to conduct an appropriate investigation of the debtor's affairs. Under the Bankruptcy Code, appointment of an examiner would appear mandatory if the debtor's fixed, liquidated unsecured debts, other than those owing to an insider, exceed $5,000,000. Several court decisions, however, have concluded that satisfaction of this standard does not mandate appointment of an examiner. The examiner's role is investigative and should not conflict with the debtor's operation of the business.

4. United States Trustee

The United States Trustee system began as an experimental pilot program pursuant to which supervisory and administrative functions formerly undertaken by the bankruptcy judge under the repealed Bankruptcy Act would be handled by the Office of the United States Trustee which is part of the Department of Justice. The system was subsequently made permanent.

The United States Trustee has standing to be heard on any issue, but its primary function is to insure the fairness and integrity of the bankruptcy system. In most cases, the United States Trustee is concerned with issues regarding: (1) formation of committees; (2) compensation of professionals retained by the debtor, the committees and trustee; (3) adequacy of disclosure statements filed in connection with a plan of reorganization; and (4) undue delay in the progress of the case.

5. Professional Persons

The debtor, each committee and the trustee may employ professional persons to represent or perform services with respect to the estate. Such professionals include attorneys, accountants, auctioneers and appraisers. Professionals are entitled to reasonable compensation for actual and necessary services rendered, as well as reimbursement for actual and necessary expenses. These

amounts are paid from the bankruptcy estate and are subject to court approval. Parties in interest may object to the retention of an amounts paid to professionals.

PART II - OVERVIEW OF ASSET SALES IN BANKRUPTCY

The Bankruptcy Code permits sales of assets of the estate in one of three ways. Assets can be sold pursuant to § 363 of the Bankruptcy Code (i) in the ordinary course of business, under § 363(c), without notice or a hearing or (ii) other than in the ordinary course of business, under § 363(b), after notice and a hearing. Assets may also be sold in a Chapter 11 reorganization as part of a plan of reorganization under § 11 23(a)(5). Sales pursuant to § 363(b) and § 11 23(a)(5) are discussed below

A. Section 363(b) Sales

Section 363(b) of the Bankruptcy Code provides that "the trustee, after notice and a hearing, may use, sell or lease, other than in the ordinary course of business, property of the estate." The notice procedure for sales under § 363(b) is set forth in Bankruptcy Rules 2002, which requires 20 day notice, and 6004, which requires than any objection to a proposed sale be filed within five days before the date set for the proposed action or set by the court. An objection to the proposed sale is a contested matter governed by Bankruptcy Rule 9014. Although § 363(b)(1) speaks in terms of "notice and a hearing," the phrase, as defined by § 102(1), allows the court to authorize the sale of assets without an actual hearing if notice is properly given and no party in interest timely requests a hearing.

Pursuant to Code § 363(f), assets can be sold pursuant to § 363(b) "free and clear" in certain circumstances. In particular, Code § 363(f) provides:

> The trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate, only if—
>
> (1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;
>
> (2) such entity consents;
>
> (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
>
> (4) such interest is in bona fide dispute; or
>
> (5) such entity could be compelled, in a legal or equitable proceeding, to
>
> (6) accept a money satisfaction of such interest.

11 U.S.C. 363(f) (emphasis added). As the above underlined words make clear, § 363(f) states that property can be sold under § 363 free and clear only of any "interest." Nowhere does the Code explicitly authorize a § 363 sale to be made free of "claims." The terms are not interchangeable.

The term "claim" is defined by the Code as any right to payment or any right to an equitable remedy for breach of performance if the breach gives rise to a right to payment, whether contingent, fixed, liquidated, unliquidated, matured or unmatured, disputed or undisputed, reduced to judgment, legal, equitable, secured or unsecured. As a general rule of thumb, a claim arising out of a transaction prior to the commencement of the bankruptcy proceeding is a pre petition claim; a claim arising from operative facts occurring after the commencement of the bankruptcy proceeding is a post petition claim.

B. Sales under a Chapter 11 Plan

Section 11 23(a)(5) of the Bankruptcy Code provides that a plan may be implemented by means of a "sale of all or any part of the property of the estate, either subject to or free of any lien." Section 1141(c) states that "property dealt with by the plan is free and clear of all claims and interests of creditors, equity security holders, and of general partners in the debtor." § 11 23(a)(5). This language is broader than the language in § 363(f) discussed above. Because of the broader statutory language in §1141(c), many commentators have noted that it might be preferable for a buyer to acquire assets under a plan under § 1129 rather than pursuant to a sale under § 363(f).

PART III - IP CONTRACTS IN BANKRUPTCY ASSET SALES

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.

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.

1. 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.

2. 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.

3. 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.

E. 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).

F. 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 [Patent Act];

(C) patent application;

(D) plant variety;

(E) work of authorship protected under Title 17 [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.

G. Drafting Tips

1. Licensor View

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. Licensee View

During the negotiation of a technology license, a licensee can take certain steps to maximize the potential benefits of section 3 65(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?

- 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?

PART IV - PAYMENT

A. The Automatic Stay

The Code provides that the commencement of a Chapter 7 or 11 case (by a voluntary petition by the debtor or an involuntary petition by creditors) acts as an automatic stay, or injunction, against a wide variety of debt collection and lien enforcement activities a creditor may be pursuing or considering, including the following:

- The commencement or continuation of all judicial, administrative, or other proceedings against the debtor to recover on a pre-petition claim;
- The enforcement of pre-petition judgments;
- Actions to obtain possession or to create, perfect, or enforce liens against any property of the debtor's estate; and
- Any acts to collect or recover on pre-petition claims, or to set off debts owed by the creditor to the debtor.

The stay is aimed at halting, at least temporarily, all litigation, foreclosure, and other creditor enforcement activities against the debtor. The stays provides the debtor with a "breathing spell," during which it may attempt to reorganize its operations and affairs for the benefit of creditors. The courts tend to be particularly concerned about protecting the interests of unsecured creditors, which as a body would be injured by an uncontrolled race to the courthouse and piecemeal dismemberment of the debtor's assets. The automatic stay voids any actions which violate it, and under certain circumstances, violators could suffer severe penalties at the hands of the bankruptcy judge. Any person injured by a willful violation of the stay may recover actual damages and, in appropriate cases, punitive damages.

B. Proof of Claim - Documenting the Pre-petition Claim

If a creditor holds any right to payment or any right to an equitable remedy for breach of performance if the breach gives rise to a right to payment, whether contingent, fixed, liquidated, unliquidated, matured or unmatured, disputed or undisputed, reduced to judgment, legal, equitable, secured or unsecured, it may file a proof of claim. Claims encompass any actions the creditor may be asserting against the debtor in a non-bankruptcy context. Any claim the creditor may hold arising out of a transaction prior to the commencement of the bankruptcy proceeding is a pre-petition claim; a claim arising from the creditor's business dealings with the debtor occurring after the commencement of the bankruptcy proceeding is a post-petition claim.

At the commencement of the case, the debtor must file schedules of any outstanding pre petition claims and liabilities, stating whether they are contingent, unliquidated or disputed. The creditor may file a form entitled "proof of claim" with the court, setting forth its claim. In a

Chapter 7 case, the deadline or "bar date" for filing claims ordinarily expires 90 days after the date the Court sets forth a so called Section 341(a) meeting. In a Chapter 11 case, the court will fix a deadline or "bar date" for filing claims and the creditor will receive notice of that date. Often the debtor will mail that notice to the creditor at the location the debtor most recently contacted. The creditor should be sure its system tracks these notices in such a way that they receive appropriate legal attention.

If a claim against a Chapter 11 debtor is scheduled as liquidated and undisputed or if no objection is filed to the claim, the claim will be deemed allowed. The Code requires the court to estimate for the purpose of allowance any contingent or unliquidated claim, the fixing or liquidation of which would unduly delay the administration of the case. Under Chapter 11, distributions will be made in accordance with the priorities pursuant to a plan of reorganization. In a Chapter 7 liquidation, distributions are made in accordance with the priority scheme set forth in the Bankruptcy Code.

A debtor or other party in interest may object to any claim, raising any defense which would have been available under bankruptcy or non-bankruptcy law. Any objection to your claim must be served, following which there will be an opportunity for hearing. Discovery procedures are available under the Bankruptcy Rules in connection with objections, thereby permitting more complicated disputes to be resolved within the objection process.

C. Administrative Expense Priority Claim

The Code provides that the costs and expenses of operating the debtor or preserving the estate in bankruptcy proceedings ("administrative expenses") are entitled to priority in order of payment out of unencumbered assets. Such costs include any "actual, necessary costs and expenses of preserving the estate," including wages, salaries, or commissions earned after the commencement of the case, and expenses incurred to creditors who provided goods and services during the case. Administrative expenses also include the cost of any fees and expenses of trustees, attorneys, accountants, examiners and other professionals, which fees are subject to review and allowance by the bankruptcy court. In a chapter 11 proceeding, the debtor must pay such administrative expenses in full on the effective date of a confirmed plan.

D. Preferences

Under applicable provisions of the United States Bankruptcy Code, a bankruptcy trustee is granted broad "strong-arm" powers to avoid (and recover from a transferee) certain transfers of property of a debtor as well as certain liens placed on such property. Among the transfers and liens which a trustee (as well as a Chapter 11 debtor) may be able to avoid are the following: post-petition transfers, fraudulent transfers, preferential transfers, set offs, statutory liens, transfers that are voidable by judicial lien holders and bona fide purchasers.

If a creditor has achieved payment on an old invoice shortly before a customer's bankruptcy case has commenced, it may be required to disgorge that payment. The basic elements of a "preference" are set forth in Section 547(b) of the Bankruptcy Code which provides that a bankruptcy trustee may avoid:

1. any transfer

2. of an interest of the debtor in property

3. to or for the benefit of a creditor

4. for or on account of an antecedent debt

5. made while the debtor was insolvent

6. on or within 90 days* before bankruptcy

7. that enables the creditor to receive more than it would have received in a Chapter

8. liquidation if the transfer had not been made

*one year if the transfer was made to an "insider"

Under Section 547(c) of the Bankruptcy Code, a Trustee may not avoid an otherwise preferential transfer if the transfer falls within one of the following exceptions:

- Contemporaneous Exchange - the transfer was made in connection with a contemporaneous exchange for new value (or was intended to be made in connection with a contemporaneous exchange), or

- Ordinary Course Payment - the transfer involves a payment made in the ordinary course of business, according to ordinary business terms, on account of a debt incurred in the ordinary course, or

- Enabling Loan - the transfer creates a security interest in property acquired by the debtor which security interest was granted pursuant to a security agreement signed at the time new value was given, which new value enabled the debtor to acquire such property, and which security interest is perfected within ten day after the debtor acquires such property, or

- Subsequent Credit Extension - if the creditor who received the preferential transfer provides unsecured credit after such transfer, then the preferential transfer is avoidable only to the extent the value of the prior preferential transfer exceeds the aggregate amount of the subsequent unsecured credit, or

- Receivables and Inventory Financing - if the transfer creates a perfected security interest in inventory or receivables, then the transfer is avoidable only to the extent that the creditors' secured position improved during the preference period.