

IP Licenses in Bankruptcy

Strategies for Licensees and Licensors to Protect IP Interests Under the Code

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Overview of Bankruptcy Code Sections Applicable to Intellectual Property

Presented by:
Jason B. Binford

February 21, 2012

Discussion Points

- A Brief Primer on Intellectual Property
- Issues Related to Trademark Licenses
- Rejection of IP License Agreements
- Assumption of IP License Agreements
 - *“Catapult”* Debate

A Brief Primer on IP

- “Intellectual Property” = Copyrights, Patents, Trademarks, and Trade Secrets
- Copyrights
 - Copyright Act of 1976, 17 U.S.C. §§ 101 – 1322
 - Protects original works of authorship
 - Provides a certain bundle of rights
 - Designed to Protect Innovation
 - Examples: articles, songs, architectural blueprints

A Brief Primer on IP

- Patents
 - Patent Act of 1952, 35 U.S.C. §§ 101 - 376
 - Patent can be obtained on any new and useful process, machine, manufacture, or composition of matter, or any useful improvement thereof
 - Deal struck between inventors and the government. Inventor discloses invention, given certain exclusive rights in exchange
 - Examples: pharmaceuticals, industrial machines, consumer electronics

A Brief Primer on IP

- Trademarks
 - Lanham Act of 1946, 15 U.S.C. § 1051 – 1127
 - Any word, name, symbol or device used to identify the source or origin of a product or service
 - Purpose is to prevent customer confusion and protect the value of identifying symbols. Unlike patents and copyrights, TMs are not intended to encourage innovation by providing a period of exclusive rights.
 - Examples: corporate logos, unique design or shape of certain products

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 nonbankruptcy law.

Bankruptcy Code Definition of Intellectual Property

- Copyrights
- Patents
- Trade Secrets
- ~~Trademarks~~

General Issues Related to IP Licenses

- Is the Debtor a Licensee or an Owner of the IP?
 - Look to the legal effect of the conveyance
 - Exclusive versus non-exclusive licenses
- Determining Whether IP Licenses are Executory Contracts
 - *In re Exide Techs.*, 617 F.3d 957 (3rd Cir. 2010)

Rejection of IP License Agreements

Section 365(n) – when a debtor/licensor rejects an “intellectual property” right license, the licensee may either:

- (1) Treat the rejection as a termination of the license agreement and seek to recover for breach of contract; or
- (2) Retain its rights under the agreement as such rights existed immediately before the bankruptcy case commenced, subject to certain limitations

Rejection of Trademark License Agreements

- Does Section 365(n) Apply to Trademarks?
- Legislative History of Section 365(n)
 - *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1984)
 - Exclusion of trademarks from Bankruptcy Code definition of “intellectual property” appears to have been deliberate
- Policy Reasons for Treating Trademarks Differently
 - Unlike owners of copyrights and patents, trademark owners must take affirmative acts to control use

Rejection of Trademark License Agreements

- Does Section 365(n) Apply to Trademarks?
 - Case law:
 - *In re Matusalem*, 158 B.R. 514 (Bankr. S.D. Fla. 1993): Yes
 - *In re Exide Techs.*, 607 F.3d 957 (3rd Cir. 2010): Court's equitable powers
 - Nearly every other case: No

Rejection of Trademark License Agreements

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

Rejection of Trademark License Agreements

- Section 365(n) May Factor Into this Analysis
 - If section 365(n) does not apply, is *Lubrizol* still good law as to trademarks?
 - How should a court weight the effects of rejection?

Rejection of Trademark License Agreements

- 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)

Assumption of IP License Agreements

- Assumption of a Non-Assignable Contract – the *Catapult* Debate
 - Section 365(c):

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 –

Assumption of IP License Agreements

- Assumption of a Non-Assignable Contract – the *Catapult* Debate
 - Hypothetical Test
 - *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
 - *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)

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When the Debtor is a Licensor of Intellectual Property

February 21, 2012

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Some Practical Examples of IP

■ Automobiles

- According to Toyota's website a single car has approximately 30,000 parts when counting every item down to the smallest screw.

■ Camera Equipment

- Nikon's recently announced flagship dSLRs, the D4 and D800, are rumored to contain 1,600 component parts. The sensor is rumored to be manufactured by Sony using a Nikon design.

■ Smartphones

- Apple's iPhone 4s reportedly contains a chipset manufactured by Qualcomm.
- Additional chipsets manufactured by Skyworks Solutions, Avago Technologies, Inc., and TriQuint.
- Flash memory manufactured by Toshiba Inc.
- Glass manufactured by Lens Technology International.

Examples (cont'd)

- **What Software Does the Typical Business License?**
 - Word Processing
 - Spreadsheet
 - E-mail
 - Anti-Virus
 - Database Management
 - Video-conferencing

- **Is this software installed locally or obtained as a service through the “Cloud?”**

Examples (cont'd)

- **As the product or information technology manager how do you protect your company (and your job) from the risks that the manufacturer or developer of a crucial component may file for bankruptcy?**
- **What are your rights as a Licensee when the debtor is a Licensor?**

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).

Executory Contracts (cont'd)

- 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. The “Domino Effect.”

Executory Contracts (cont'd)

- **Most courts have adopted the Countryman test.** See, e.g., *Matter of Superior Toy & Mfg. Co., Inc.*, 78 F.3d 1169, 1172 n.3 (7th Cir. 1996); *In re Streets & Beard Farm P'ship*, 882 F.2d 233, 235 (7th Cir. 1989); *In re: Bradlees Stores, Inc.* 2001 WL 1112308, at *6 (S.D.N.Y. Sept. 20, 2001) (collecting cases).
- **A “Countryman-plus” Approach**
 - Some courts have found that the Countryman test is “helpful but not controlling” and use a “functional approach that “further[s] the policies of the Bankruptcy Code.”
 - Under the functional approach, a contract is executory if the determination would permit the debtor to reject the contract because it is burdensome or unfavorable. See, e.g., *In re La Electronica, Inc.*, 995 F.2d. 30, 322 n.3 (1st Cir. 1993) (collecting cases).

Is Your IP License Really Executory?

- Do not simply assume that because the contract is titled “License Agreement” that it is an executory contract for bankruptcy purposes.
- Are there sufficient unperformed obligations on both sides to warrant treatment of the license as executory?
- The mere obligation to pay royalties standing by itself may be insufficient to cause the contract to be deemed “executory.” See *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc. (In re: Richmond Metal Finishers, Inc.)*, 756 F.2d 1043, 1045 (4th Cir. 1985).

Is Your IP License Really Executory?

- Most IP license agreements are executory.

- **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.

- **Examples of on-going Licensee Obligations:**
 - (a) agreement to use the IP in a specified manner;
 - (b) territory restrictions;
 - (c) reporting obligations.

Be Careful of the Disguised Sale

- An exclusive “license” that exhausts the economic life of the property may 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). An exclusive license is more likely to be held to be a disguised sale than is a non-exclusive license.
- However, even a non-exclusive license may constitute a disguised sale if the economic realities of the deal 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).
- The key to distinguishing an executory contract from a disguised sale is the presence or absence of continuing duties on both sides of the deal. See *Encino Brs. Mgmt. Inc. v. Prize Frize Inc. (In re Prize Frize Inc.)*, 150 B.R. 456, 460 (9th Cir. BAP 1994).

Principles & Consequences of Rejection

- Section 365(g) addresses the effects of contract 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, the parties' substantive rights under the contract are not affected.

- Examples:
 - amounts due under the contract
 - damages for breach
 - arbitration clauses
 - security interests created by the contract

Assumption and Rejection Basics

- Requires bankruptcy court approval.
- Usually evaluated using the business judgment rule.

Chapter 11

- IP licenses generally can be assumed or rejected at any time before plan confirmation. See 11 U.S.C. § 365(d)(2).
- Chapter 7 case
 - 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).

The Protection of 365(n)

- Adopted in 1988 in response to the Fourth Circuit's ruling in *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc. (In re: Richmond Metal Finishers, Inc.)*, 756 F.2d 1043, 1045 (4th Cir. 1985).
- *Lubrizol* permitted a debtor-franchiser to reject franchise agreements with non-debtor franchisees merely upon a finding that the rejection met the “business judgment” test.

Section 365(n)

- 365(n) was adopted in an attempt to balance the bankruptcy policy of allowing debtors to reject burdensome contracts with the policy of intellectual property law favoring scientific and technological advancement.
- Section 365(n) does not deal with the effect of rejection by the licensee.
- Section 365(n) does not deal with the question of whether a licensee can assume or assume and assign a license agreement.

Section 365(n)

- 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).

Section 365(n)

■ Option 2:

- Retain the rights under the license agreement as those rights existed immediately before the bankruptcy case was commenced, subject to the following conditions:
 - (1) Licensee must make all “royalty” payments due under the contract for the duration of the contract period **and** for any period that the licensee could have extended the contract under applicable nonbankruptcy law; see 11 U.S.C. 365(n)(1)(B)(i)-(ii); and
 - (2) Licensee must waive any right of set-off it may have under the contract; and any claims under section 503(b) of the Bankruptcy Code stemming from the performance of the contract. See 11 U.S.C. § 365(n)(2).

Section 365(n)

- If the licensee opts for Option 2 and makes a written request of the trustee, the trustee must:
 - To the extent provided in the contract or an agreement supplementary to the contract, provide to the licensee any intellectual property (including such embodiment) held by the trustee; and
 - 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.

Section 365(n)

- What happens while the debtor is trying to make a decision on assuming or rejecting?
- 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

Section 365(n)

- What happens if IP has been licensed from a foreign entity.
- *In re Qimonda AG*, 2011 WL 5149831 (Bankr. E.D. Va. 2011)
 - A Chapter 15 case.
 - 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).

What Happens When the Debtor-Licenser Sells the IP Using Section 363?

- In a 363 sale, the debtor seeks bankruptcy court permission to sell assets outside of the ordinary course of business.
- The debtor often uses a 363 sale to sell assets in a chapter 11 case rather than as part of a plan or reorganization.
- The 363 sale often involves the sale of all or substantially all of a debtor's business as a going concern.

363(f) – Sale “Free and Clear”

- A debtor selling assets pursuant to section 363 usually seeks to sell its assets “free and clear” of all liens and interests.
- A sale can be made “free and clear” pursuant to 11 U.S.C. § 363(f) if any one of five conditions are met:
 - (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.

363(f) and 365(n) Interplay

- Most commentators in the secondary literature and a number of bankruptcy courts have operated on the assumption that the protections of 365(n) extend to 363 sales.
- But, in the mid-2000s, the Seventh Circuit decided a pair of cases that rejected those assumptions.

363(f) and 365(n) Interplay

- *Future-Source L.L.C. v. Reuters, Ltd.*, 312 F.3d 281 (7th Cir. 2002)
 - Seventh Circuit concluded that a 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.
 - Judge Richard Posner explained that for the sake of efficiency it is necessary to read an implied consent mechanism into the Bankruptcy Code so that overall transaction costs leading up to the sale are controlled.
- The *Future-Source* decision did not explicitly address the licensee protections of section 365(n).
- However, the clear implication was that in certain circumstances intellectual property could be sold free and clear of a licensee’s interest despite the protections afforded by section 365(n).

363(f) and 365(n) Interplay

- *Precision Industries, Inc. v. Qualitech Steel Corp.*, 327 F.3d 537 (7th Cir. 2003)
- The Seventh Circuit ruled on the reach of section 365(h):
 - Section 365(h) is designed to protect real property lessees in the same way intellectual property licensees are protected under section 365(n).
 - 365(h) and 365(n) are generally viewed as being analogous to each other.

363(f) and 365(n) Interplay

- *Qualitech*
 - A debtor-lessor could sell underlying real estate free and clear of any leases, despite the protections afforded lessees in section 365(h), because the statutory provisions of 363(f) and 365(h) do not suggest that one supersedes or limits the other.
- Together, *Future-Source* and *Qualitech* suggest that, at least in the Seventh Circuit, section 365(n) offers no special protection to IP licensees in a 363 sale.

363(f) and 365(n) Interplay

- No other Circuit Courts have ruled on this issue.
- Multiple courts around the country, including in the Southern District of New York, have followed the “implied consent” logic in *Future-Source*.
 - See, e.g., *In re GSC, Inc.*, 453 B.R. 132, 183 (Bankr. S.D.N.Y. 2011); *In re Jennifer Convertibles, Inc.*, 2010 Bankr. LEXIS 6068 (Bankr. S.D.N.Y. July 29, 2010).
- See also *Licensing by Paolo, Inc. v. Sinatra (In re Gucci)*, 126 F.3d 380 (2d Cir. 1997), where the Second Circuit held that rights to a trademark can be sold in a 363 sale “free and clear” of all prior interests of licensees and sublicensees.

363 Sales – How Licensees Can Protect Themselves

- Monitor the debtor's case for new developments.
- Read notices that are sent out by the debtor.
- Make sure that you assert your objections in a timely manner.
- Bankruptcy cases move quickly and bankruptcy judges rarely undo sale orders.
- Objecting after the deadline will generally be too late.
 - **“Scream or Die”**
 - **“Speak now or forever hold your peace”**

Practical Considerations

- Section 365(n) is not perfect, but it leaves licensees of intellectual property in a better position than most holders of executory contracts.
- Is the contract executory?
 - If you want section 365(n) to apply, consider inserting appropriate clauses and obligations in the contract.
 - The applicability of 365(n) will still be determined by the bankruptcy court, but the parties' intent can go a long way.
- Consider combining into one document all licenses that can be protected under section 365(n), such as patents, copyrights, trade secrets, and mask works, with items that cannot be protected, such as trade marks, trade names, and internet domain names.
- As an equitable matter, a bankruptcy court may be more inclined to permit the continued use of portions of a contract that are not covered by section 365(n) if those rights are interrelated with covered rights, and the majority of the rights conferred in the agreement are protected by section 365(n).

Practical Considerations

- Identify what your payments are for in both your contract and when you make them.
 - If the licensor later files for bankruptcy, this paper trail may save you money if you opt to continue using the license. You may be able to avoid paying for items that section 365(n) does not allow you to continue using.
- Consider using a third-party escrow agent where appropriate.
- Structure the payments to discourage rejection in the first place.

Executive Summary

- **Section 365(n) protects IP licensees when the licensor files for bankruptcy relief**
- **The protections afforded may fall short of a licensee's full contract rights**
 - Trademarks not protected
 - Only covers IP that existed on the date of the bankruptcy filing
- **Despite section 365(n), a licensee is still at risk of losing his interest in the IP if the debtor-licensor attempts a sale under section 363(f)**
 - Be wary of implied consent to the sale

Jeffrey S. Berkowitz

Jeffrey S. Berkowitz has extensive experience representing privately and publicly held companies in various complex commercial, bankruptcy, product liability and class action litigation matters involving corporate governance, telecommunications, internet telephony, insurance coverage, internal investigations, judgment enforcement, collection, note and guarantee and employment law.

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- Debtor, creditor and fiduciary representations in bankruptcy proceedings, pre-bankruptcy "workout" and insolvency counseling, and related state court litigation involving receiverships, attachments, replevins and foreclosure actions
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- Represented principal parties in some of the cutting edge decisions in this area in the last decade;
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DEBTOR AS LICENSEE OF INTELLECTUAL PROPERTY

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SECTION 365(N) DOES NOT APPLY WHERE THE DEBTOR IS THE LICENSEE

- Section 365(n) by its terms applies only where the debtor is the licensor of intellectual property and has no applicability where the debtor is the licensee.
 - When a debtor licensee rejects an intellectual property license, the licensor receives an unsecured claim for damages arising out of a deemed breach of the license as of the petition date.
 - Note that if a debtor rejects a license after previously assuming it, the licensor will be entitled to an administrative expense claim for damages arising from the rejection.
 - Non-debtor licensor entitled to an administrative expense claim for any use of the license prior to rejection.
 - Non-debtor licensor may, if unduly burdened by the debtor's failure to assume or reject the license, move to compel the debtor either to assume or reject the license.
 - Such a motion will not likely succeed early on in the case, but may be successful at a later stage of the case.

Requirements for Assumption and Assignment

- Assumption or rejection of an intellectual property license is possible only where the license is an executory contract.
- Debtor in possession (or trustee) must cure any existing defaults, other than defaults relating to the insolvency or financial condition of the debtor, the commencement of a bankruptcy case, the appointment of a trustee, or the satisfaction of a penalty provision relating to non-monetary obligations. (Sec. 365(b)).
- Debtor in possession (or trustee) must also provide the non-debtor licensor with adequate assurance that it (or its assignee) will be able to perform under the license.
 - Adequate assurance doesn't necessarily mean perfect assurance, but should indicate debtor or assignee's ability to perform under the license and to cure any future defaults.

Effect of Assumption, Assignment or Rejection

- If the license is assumed, the debtor retains its rights under the license, and assumes its obligations to the licensor.
 - Following assumption, the debtor must comply with all ongoing obligations under the license. Subsequent breach of the license will give the licensor an administrative claim in the licensee's bankruptcy case.
- If the license is assumed and assigned, the debtor transfers all rights and obligations under the license to a third party.
 - License agreements (and other executory contracts) must be assumed and assigned as a whole. Debtor may not assume, or assume and assign, beneficial portions of the license while rejecting burdensome portions.
 - Where a license agreement is entered into at the same time as other, related contracts, the court may find that the license agreement along with the related contracts form a single, integrated contract. In that case, all contracts integrated with the license agreement will must be assumed or rejected together. (See In re Exide Tech., 2010 WL 2163190 at *1 (3d Cir. 2010) (noting that four agreements, a Trademark and Trade Name License Agreement, an Asset Purchase Agreement, an Administrative Services Agreement and a letter agreement together formed a single integrated agreement).
- If the license is neither assumed nor rejected, it will “ride through” the bankruptcy and continue to be binding on the debtor.
 - As a result, most reorganization plans state that if a contract is not specifically rejected it will be assumed (in the case of reorganization plans) or vice versa (in the case of liquidation plans).

Standards for Assumption or Assumption and Assignment

- In addition to the above requirements, debtors must show that the assumption, assumption and assignment, or rejection is in the best interests of the estate.
 - In the case of rejection, the debtor need only show that rejection is in the best interests of the estate.
 - Effect of rejection on the counterparty generally not relevant (unless effect on counterparty is so disproportionate to benefit to estate as to indicate that decision was manifestly unreasonable or made in bad faith).
 - The size of a claim resulting from the rejection is generally not considered by the court. It could be considered if the claim would be so large as to significantly dilute other creditors while offering no benefit to the debtor (though this would be an unusual circumstance).
- In evaluating the debtor's decision in this respect, courts will generally defer to the debtor's business judgment.
 - Higher standards may apply in cases involving regulated industries or contracts.
- Section 365(e) invalidates anti-assignment clauses in intellectual property licenses.
 - This provision does not apply to contracts with respect to which "(i) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to the trustee or to an assignee of such contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and (ii) such party does not consent to such assignment or assumption."

Timing of Assumption or Rejection Decision

- Debtors generally may assume or reject intellectual property licenses at any time from the commencement of the case through the confirmation of the plan.
 - Non-debtor licensors may attempt to compel the debtor to assume or reject the license at an earlier time.
 - Such requests are not often granted at an early stage in the case. However, they may be renewed at a later time, and may be granted if the non-debtor counterparty can demonstrate a significant burden resulting from the failure to assume or reject the contract

Section 365(c) – Still Unsettled

- Section 365(c)(1) of the Bankruptcy Code provides that “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.”
 - Intellectual property licenses are generally licenses with respect to which applicable law excuses the licensor from accepting performance from or rendering performance to any party other than the original licensee.

Hypothetical Test Versus Actual Test

- The majority of circuit courts to have considered the issue hold that Section 365(c)(1) prevents the debtor from assuming an intellectual property license even when the debtor has no intention of actually assigning the license to a third party but merely intends to continue using the license itself.
 - Third, Fourth, Ninth and Eleventh Circuits have adopted this “hypothetical” test. See *In re West Elecs., Inc.*, 852 F.2d 79, (3d Cir. 1988); *RCI Tech. Corp. v. Sunterra Corp. (In re Sunterra Corp.)*, 361 F.3d 257 (4th Cir. 2004); *Perlman v. Catapult Entm’t, Inc. (In re Catapult Entm’t, Inc.)* 165 F.3d 747 (9th Cir. 1999); *City of Jamestown v. James Cable Partners, L.P. (In re James Cable Partners, L.P.)* 27 F.3d 534 (11th Cir. 1994).
 - referred to as “hypothetical” test because it looks to whether the license could, hypothetically, be assumed and assigned to a third party.

- The First and Fifth Circuits, by contrast, have adopted an “actual” test, holding that section 365(c)(1) prohibits assumption of an executory contract only where circumstances indicated that the debtor actually intends to assign the contract to a third party from whom the licensor would be excused by applicable law from accepting performance.
- To the extent the Debtor has licenses which are important to the operation of its business, this circuit split could drive venue decisions.
 - Important due diligence item.

Effects of Rejection

- If the license is rejected, the license is treated as having been breached as of the commencement of the bankruptcy case, the debtor loses all rights to use the intellectual property under the license and is relieved of all ongoing obligations under the license.
 - Rejection is a breach of the license, not a termination.
 - As a result, other provisions of the license (e.g., arbitration provisions) may remain enforceable.
 - Rejection entitles the licensor to an unsecured claim for damages resulting from breach of the contract.
 - Licensor may also have an administrative expense claim to the extent the intellectual property was used prior to the rejection of the license.