

IP Licenses in Bankruptcy: Navigating Sec. 365 and Divergent Circuit Rulings

Strategies for Licensees and Licensors to Protect IP Interests

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Overview of Bankruptcy Code Sections Applicable to Intellectual Property

Presented by:
Jason B. Binford

December 10, 2013

Discussion Points

- A Brief Primer on Intellectual Property
- Issues Related to Trademark Licenses
- Bankruptcy Basics – Executory Contacts, Assumption and Rejection
- Rejection of IP License Agreements
- Bankruptcy Basics – 363 Sales
- Sales Free and Clear / “Disguised” Sales

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~~

Bankruptcy Basics - Executory Contracts

- Countryman definition
 - A contract where material unperformed obligations remain on both sides as of the petition date

Bankruptcy Basics – Assumption and Rejection

11 U.S.C. § 365

(a) “....the trustee, subject to the court’s approval, may assume or reject any executory contract or unexpired lease of the debtor.”

Bankruptcy Basics – Assumption and Rejection

- Assumption
 - Upon assumption, the debtor must:
 - Cure
 - Provide adequate assurance of future performance
 - Contract or lease is assumed "*cum onere*" – debtor cannot alter the terms

Bankruptcy Basics – Assumption and Rejection

- Rejection
 - 365(g) – Rejection acts as a prepetition breach of the contract or lease. While the debtor is relieved of obligations under the agreement, legally speaking, rejection is not a termination of the agreement.
 - Non-debtor party receives an unsecured claim for its rejection damages

- Determining Whether IP Licenses are Executory Contracts

- *In re Exide Techs.*, 607 F.3d 957 (3rd Cir. 2010)
- *In re Interstate Bakeries Corp.*, 690 F.3d 1069 (8th Cir. 2012)
 - Panel decision was vacated by the 8th Circuit and a en banc hearing was conducted September 26, 2013
 - no decision yet

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. 1985)
 - 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), Ambro, J., concurring: Even if 365(n) doesn't apply, a court may use its equitable powers to address the situation
 - Most other cases: 365(n) does not apply to the rejection of trademark licenses

Rejection of Trademark License Agreements

- *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*, 686 F.3d 372 (7th Cir. 2012)
 - Specifically disagrees with *Lubrizol*. But, also rejects Judge Ambro's "equitable" analysis
 - Rejection \neq termination per 11 U.S.C. § 365(g)
 - Therefore, a trademark licensee retains its contractual rights post-rejection

Rejection of Trademark License Agreements

- Section 365(n) May Factor Into this Analysis
 - Outside of the Seventh Circuit, 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

- 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

Bankruptcy Basics – Section 363 Sales

11 U.S.C. § 363

(b)(1) “The Trustee, after notice and a hearing, may use, sell or lease, other than in the ordinary course of business, property of the estate”

Bankruptcy Basics – Section 363 Sales

“Disguised Sales” – 365 vs. 363

- Issue: is an exclusive “license” really an asset sale, rather than an executory contract?
- Courts will look to the economic realities of the deal (the effect of the conveyance) and factors such as whether the license was exclusive and what, if any, other obligations the “licensor” retained

Bankruptcy Basics – Section 363 Sales

11 U.S.C. § 363(f) – Sales “free and clear” of liens, claims and encumbrances

- 363(f) and 365(n)

- *Future-Source L.L.C. v. Reuters, Ltd.*, 312 F.3d 281 (7th Cir. 2002)
- *Precision Industries, Inc. v. Qualitech Steel Corp.*, 327 F.3d 537 (7th Cir. 2003)

Bankruptcy Basics – Section 363 Sales

363(f) and 365(n)

Principal lesson: licensors must monitor a bankruptcy case closely and must speak up to protect its rights.

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Treatment of IP Licenses in Bankruptcy*

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*Thanks and recognition to Jeffrey S. Berkowitz at Gibbons for a portion of these materials.

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. (Deals with effect of rejection by licensor/debtor)
- 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) *cont'd*

- 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) *cont'd*

■ 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? See, *Szombathy v. Controlled Shredders, Inc.*, 1996 W.L. 417121 (Bankr. N.D. Ill. 1996)
 - (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

Section 365(n) *cont'd*

- (2) What are royalties? See *In re Prize Frize, Inc.* 32 F.3d 426 (9th Cir. 1994).
- (3) 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).
- Licensee entitled to enforce exclusivity provisions
- Licensee does not get such things is right to receive any modifications, updates, etc.

Section 365(n) *cont'd*

- 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.
- * Option 2 must be affirmatively exercised. Failure to elect may result in presumption of termination. In re EI International, 123 B.R. 64 (Bankr. D. Idaho 1991).

Section 365(n) *cont'd*

- What happens if IP has been licensed from a foreign entity.
- *In re Qimonda AG*, 462 B.R. 165 (Bankr. E.D. Va. 2011)
 - District Court remanded to consider 2 questions:
 - A. Does limiting applicability of 365(n) in Chapter 15 appropriately balance the interests of debtor and the licensees as required by Section 1522(a)?
 - B. Would granting comity to German Insolvency Law be “manifestly contrary” to US public policy?
 - On remand, bankruptcy court held that
 - A. Failures to apply 365(n) in this case and this industry would undermine fundamental U.S. public policy.
 - Balancing of debtor and creditor interest favors application of 365(n) because U.S. patents could still be licensed to other parties and existing licensees had made substantial investment in reliance.

Issues Where Debtor is Licensor

- Upon rejection, regardless whether of licensee's election, the debtor is relevant of all affirmative obligations under license except for covenant not to use for infringement, violations of licensed exclusivity provisions, confidentiality provisions
- e.g. Debtor need not provide maintenance, technology updates, upgrades, consultations, etc.
- Distinction between passive and affirmative performance

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;

363(f) – Sale “Free and Clear”

- (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.
- *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.

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.

365(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.

Practical Considerations

- 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.
- Focus on the choice of law provision.

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.

Section 365(n) Does Not Apply Where the Debtor is the Licensee *cont'd*

- Non-debtor licensor entitled to an administrative expense claim for any use of the license prior to rejection. But see *Microsoft Corp. v. DAK Industries, Inc. (In re DAK Industries, Inc.)*, 66 F.3d 1091 (9th Cir. 1995)
- 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.
- What about payments from E to Z doing "limbo period"?
 - Administrative claim – administratively insolvent licensee/debtor
 - Even if solvent, what is amount of claim
 - Take security interest payment, See *In re DAK Industries, supra*.

Section 365(n) Does Not Apply Where the Debtor is the Licensee *cont'd*

- Non-Debtor Licensor should move to compel assumption or rejection as soon as possible, and payment of full amount under license.

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)).

Requirements for Assumption and Assignment

cont'd

- 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.

Effect of Assumption, Assignment or Rejection

cont'd

- 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.

Effect of Assumption, Assignment or Rejection

cont'd

- 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., 607 F.3d 957 (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).

Effect of Assumption, Assignment or Rejection

cont'd

- 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).

Standards for Assumption or Assumption and Assignment *cont'd*

- 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.

Standards for Assumption or Assumption and Assignment *cont'd*

- 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.”

Section 365(c) – Still Unsettled *cont'd*

- 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.

Hypothetical Test Versus Actual Test *cont'd*

- 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.

Hypothetical Test Versus Actual Test *cont'd*

- 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.

Tips for Licensees

- Obtain right to assign.
- Object to ipso facto clauses as unenforceable but See 365(e)(2)(A).
- Ensure that any information needed from licensor remains available in event of bankruptcy.
 - Place needed trade secret information of licensor, e.g. biological materials or sequences, in escrow.
 - Escrowed material becomes available upon bankruptcy of licensor.
- Obtain security interest in licensed IP
 - Perfection depends on type of IP.

Thank You

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