Necessary evils: anticipating bankruptcy in licensing agreements

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Necessary evils: anticipating bankruptcy in licensing agreements

*Bankruptcy is a risk that should always be addressed in licensing agreements, says **Lori Lesser** of **Simpson Thacher & Bartlett LLP** in New York*

The old saying goes that nothing is certain but death and taxes. For corporations today (which have perpetual lives), bankruptcy is a certain risk – for either the company itself or a party with whom it does business. The bankruptcy of a large-scale vendor, distributor, customer, licensor or licensee leaves havoc in its wake, as business partners suffer unexpected disruptions and loss of profits. For a party to an intellectual property licence, the outcome can be worse – a licensor may have to share its unique brand or technology with a new, unwelcome licensee or a licensee may be blocked from using a critical asset. The prudent corporation today drafts all IP licences with bankruptcy in mind.

In a US bankruptcy proceeding, as part of its duty to maximise value for the estate, the trustee (or debtor-in-possession) has broad powers under Section 365 of the US Bankruptcy Code, 11 USC §365, to reject (breach) or assume (continue performing under) all of the debtor's "executory contracts", or those with material ongoing performance obligations. An outright sale of IP is not "executory" under Section 365, because the parties' obligations – to pay the purchase price and to deliver any documentation or related materials – are performed at closing. An IP licence is an executory contract, because the parties have multiple ongoing obligations. For example, the licensor must refrain from suing the licensee for infringement (the raison d'etre of a licence), exercise quality control over the use of its licensed trademarks and/or maintain and enforce the licensed IP. Meanwhile, the licensee must honour all territorial and field restrictions, maintain quality standards for branded products and/or assist in enforcement proceedings.

Both parties to an executory contract have much to lose in bankruptcy. If the IP licensor goes bankrupt and rejects the licence, this is deemed to be a pre-petition breach, for which the licensee has a pre-petition damages claim. Yet money is small consolation to the licensee who can no longer use a unique brand or technology. Moreover, unless the IP licensee has a security interest in the licensed property (as discussed below), its damages claim will not be paid in full. On the other hand, if the IP licensee goes bankrupt, the licensor fears it will assign the licence at auction to an unwelcome party. While royalty payments are equally green from any licensee, the IP licensor's priority is controlling access to its valuable rights, and the winning bidder at auction may be a competitor.

The US laws on bankruptcy and licensing take the concerns of licensors and licensees into account.

Licensor concerns – maintaining control

Under the US Bankruptcy Code, the debtor can assume or assign almost all executory contracts. For a narrow category of contracts defined in 11 USC §365(c), the identity of the original signatories is viewed as mission-critical, and the debtor cannot substitute a new party without the non-debtor's consent. Section 365(c) agreements include contracts for personal services (eg, if you hire Madonna to sing at a festival, she cannot send me instead), government contracts and, as pertinent to this article, intellectual property licences.

In general, the courts are more sympathetic to the IP licensor that seeks to prevent the bankrupt licensee from assigning a non-exclusive licence. This is because a non-exclusive licence – which is often granted to

settle litigation or in a divestiture – is viewed as intended only for a particular licensee. The licensee generally cannot exploit the licence monetarily and is primarily seeking protection from suit by the licensor. A licensor may wish to grant such protection to Company A, but not to Company B. Therefore, the US courts hold that a bankrupt licensee cannot transfer its rights in a non-exclusive IP licence without the licensor's consent. The law is less settled on exclusive IP licences in bankruptcy. The US courts have noted that exclusive licensees have quasi-ownership rights in the licensed property because they can prevent the licensor itself from using it. Some courts hold that these rights are sufficient to allow the licensee to transfer the licence without obtaining consent. The majority view, however, is that an exclusive licensee is still not the IP owner and, therefore, needs the owner's consent to transfer its licence in bankruptcy.

The courts' protection of IP licensors from unwanted assignments does not end their bankruptcy risk, however. Section 365 allows the debtor to assume (continue for its own use) or assign executory contracts without the licensor's consent, unless the contract is of the narrow type in Section 365(c). Yet the US courts are currently split on whether, even if the IP licence can't be assigned without the licensor's consent, the licensee may still assume the licence for its own use. The appeals courts of the Third, Fourth, Ninth and Eleventh Circuits, which cover the mid-Atlantic, Southeast and West Coast regions, hold that a licensee cannot assume or assign an IP licence in bankruptcy without the licensor's consent, based upon the precise language of the US bankruptcy statute. In contrast, the appeals court of the First Circuit, which covers New England, holds that the pre-bankrupt and post-bankrupt IP licensee are functionally the same entity and, therefore, the IP licensee may continue to use its license in bankruptcy.

Licensee concerns – maintaining access

An IP owner's bankruptcy can destroy its licensees, if it rejects a core technology or trademark license. To mitigate such potential harm, Congress enacted the Intellectual Property Bankruptcy Protection Act of 1988 to create Section 365(n) of the Bankruptcy Code. Section 365(n) provides that, if an IP licensor declares bankruptcy and rejects a licence, the licensee can essentially override the rejection and retain its rights under that agreement (and any supplementary agreements, such as source code escrow agreements for software licences). To retain its licensed rights, the IP licensee must continue to honour all of the licence's terms, such as paying all royalties and curing any breaches.

Section 365(n) has enabled many technology companies to sleep better at night. Yet its protection in a licensor bankruptcy is far from complete:

First of all, trademarks, domain names and related rights are not covered by the rejection override, which applies only to patents, copyrights, mask works and trade secrets. In sum, Section 365(n) was designed to help technology and biotech companies, for which licences to pharmaceutical patents or copyrightable software programs are essential. The licence to use a trademark or domain name is less critical from a legal perspective (although perhaps not from a marketing one), since one can always sell the same product under a different name.

Second, the Section 365(n) rejection override covers only licensed IP that exists as of the date of the bankruptcy filing. The IP licensee has no right to use IP created after the bankruptcy, such as improvements to patents or a new software release. This time limit is critical for licences to real-time content – the right to continue broadcasting headlines and news stories from months ago is virtually worthless. Further, the licensee has no right to post-bankruptcy services relating to the IP, such as maintenance, support and training, and an initial software release may become obsolete over time.

Avoiding problems at the outset

While the bankruptcy courts have wide latitude to dispose of IP licences, corporations can improve their chances of a favourable outcome (or of avoiding bankruptcy entirely) by following some practical suggestions.

From a licensee's perspective, the following points should be considered:

- Outright ownership. As much as possible, companies should create or own via assignment their mission-critical IP, thereby removing the risk of a licensor's bankruptcy.
- Bankruptcy-remote vehicles. If a company must license critical IP, the best defence is a good offence – prevent the licensor from going bankrupt in the first place. IP licensees can demand that licensed rights reside in a bankruptcy-remote special purpose vehicle. This is customarily a limited liability corporation (LLC) for which the IP licensee has consent rights over certain corporate events, such as any bankruptcy filing. Thus, the IP licensor cannot go bankrupt voluntarily without the licensee's consent. An involuntary bankruptcy is not likely, because the LLC is a holding company that lacks creditors.
- Security interests. If the licensor's

bankruptcy cannot be prevented, the IP licensee gains substantial leverage by taking a security interest in the licensed property. A security interest removes any economic incentive for the IP licensor to reject a licence in bankruptcy, for the following reason. A rejection is treated as a pre-bankruptcy breach, for which the IP licensee would have (but for the security interest) an unsecured claim for damages for its lost value, which is likely paid at less than 100 cents on the dollar. So if the licensee has a perpetual, royalty-free licence granted after a spin-off, the IP licensor could reject the licence in bankruptcy and resell it on the open market for fair market value. The licensor would receive a hefty sum from the new licensee, pay off the rejected licensee's unsecured claim for damages – which are equal to the value of its lost licence – at less than 100 cents on the dollar, and pocket the difference. In contrast, if the licensee has a security interest, it is entitled to the full value of its collateral. Therefore, any money the IP licensor receives from a new licensee must be paid 100% to the rejected licensee to satisfy its damages claim. The licensor cannot profit from a rejection and resale, and therefore, should not attempt it.

- Memorialise your rights. IP licensees should have the licence state explicitly that the parties wish for the protections of Section 365(n) to apply fully if the licensor declares bankruptcy. While the court will decide independently if Section 365(n) applies, stating this as the parties' clear intention will support such an outcome.
- Combine licensed rights. Whenever possible, IP licensees should combine in one document a licence to patents, copyrights, trade secrets or mask works on the one hand, and related trademarks or domain names on the other. As noted above, the rejection override in the Bankruptcy Code protects patents, copyrights and related rights, but not trademarks or domain names. Bankruptcy courts may be less likely to reject only one section of a licence, if the majority is protected by Section 365(n) and the rights are all interrelated.
- Pay as you go. IP licensees should try to pay royalties throughout the life of the agreement, rather than a large up-front fee. If a bankrupt licensor rejects the agreement, the licensee is excused from future payment obligations. In contrast, for an unsecured licensee, a large up-front payment is gone forever, and will not be repaid in full. Further, if the licensee is financially solvent and the licence will produce a large future royalty stream, the licensor may not reject the licence at all.
- Label the payments. IP licensees should clearly label which fees due are allocated to (i) royalties for copyrights or patents versus trademarks; (ii) pre-existing IP versus future improvements; or (iii) IP rights, versus services such as maintenance or support. As discussed above, the latter of each category is not protected by the Section 365(n) rejection override. Yet, Section 365(n) requires a licensee to pay all monies due to keep its licence. If the agreement calls for one undifferentiated payment, the licensee may have to pay it all to retain only limited rights after bankruptcy.
- Live in the present. Section 365(n) covers only licences that are in effect when the licensor declares bankruptcy. The courts have held that licences taking effect upon contingent events – such as once the licensee hits certain revenue targets or a joint venture dissolves – are not covered by the rejection override, if the licensor goes bankrupt before the triggering event occurs.
- Exercise self-help. Except for mass-market, off-the-shelf licences offered on a take-it-or-leave-it basis, software licensees should require the licensor to place the existing source code (and improvements, upon their creation) with a third-party escrow agent, who will give the IP licensee possession if the licensor goes bankrupt and refuses to perform maintenance services. In such case, the licensee can exercise self-help and modify the software on its own.
- Exercise sub-licensor help. IP sub-licensees of technology should require the sub-licensor to enforce its own rights in the bankruptcy of the ultimate IP owner. The sub-licensee and the IP owner do not have a direct contractual relationship, and so the sub-licensee cannot directly participate in the IP owner's bankruptcy. If the sub-licensor does not defend its own licensed rights vigorously, both parties will be harmed by the result.
- Object early, object often. If the licensed property is sold in an auction of the bankruptcy estate, the IP licensee must object as needed to protect its licensed rights. While Section 365(n) provides a rejection override, this right may be extinguished by the estate sale, which occurs "free and clear of any interest" unless certain exceptions apply. A recent US appeals court case held that a real estate tenant, who has analogous rights to an IP licensee in bankruptcy, lost its rejection override when it failed to object to

the sale of the land and factories in which it had a leasehold.

From a licensor's perspective, the following points should be considered:

- Know your licensee. The IP licensor's greatest fear is that its licensee will go bankrupt and assign its licence to a competitor or assume the licence and use it under a new, unwelcome owner. The best strategy is for IP licensors to choose their licensees wisely and to focus on their financial health. The licensor may wish to restrict its licensees from incurring excessive debt or require that their licences terminate at the first signs of insolvency – well before a bankruptcy petition is filed.
- Know the law. As noted above, the US appeals courts are split as to whether an IP licensee can assume its licence in bankruptcy, without the IP licensor's consent. Four appeals courts require the licensor's consent and one appeals court does not. Therefore, IP licensors will want their contracts governed by state laws subject to the pro-licensor appeals courts (which cover the West Coast, mid-Atlantic and Southeast regions). In addition, IP licensors should draft broad anti-assignment clauses that require their consent for any assignment by the licensee, including assignments implied at law due to a merger or change of control or assignments to affiliates. Such language will indicate to the bankruptcy court that the licensor's opposition to assignment is absolute, and support any claims of irreparable harm.