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Protecting IP Rights Before A Bankruptcy Filing

Law360, New York (August 11, 2009) -- How should a licensor/licensee of intellectual property protect its IP rights in the event of the potential bankruptcy of an existing or prospective corporate partner?

Background

In the current economic climate, corporate licensors and licensees of intellectual property are expected to file for bankruptcy in greater-than-usual numbers.

Many financially sound companies have licensed out or licensed in intellectual property rights from companies that are now financially challenged. In the event of bankruptcy, one company's financial problems could become the other company's IP problem.

For example, suppose a licensor files a bankruptcy petition. The licensee of the licensor's intellectual property may not be able to run its commercial operation because to do so, the license agreement must remain intact.

Alternatively, assume a licensee files for bankruptcy. The licensor may worry that it will not collect all of its valuable license revenue. The licensor may also be concerned that the debtor licensee will assign in bankruptcy the license agreement to an unwanted third party.

In a Chapter 11 reorganization, the trustee/debtor in possession has the right, post-petition, to reject (breach) or assume (retain) executory contracts subject to court approval.

If assumed, the debtor may also have the right to assign the executory contract to a third party, notwithstanding the presence of a "no assignment" clause in the contract.

A contract is called “executory” when performance by both parties has yet to be completed and when the failure to perform by one party will result in a breach excusing the performance of the other.

Intellectual property licenses are typically executory because the licensor has the continuing obligation not to sue its licensee for infringement (and, in the case of an exclusive license, also not to license to others), and the licensee has the continuing obligation to pay royalties.

The debtor then does a cost/benefit analysis to decide whether it makes sense, as part of a reorganization plan, to reject or assume the license agreement. A rejection or assumption of a license agreement, with or without a subsequent assignment, can have negative commercial consequences for the non-debtor.

When the Client is the Licensee

When the client is the licensee of intellectual property and the licensor has filed for bankruptcy reorganization, the client may worry whether it can continue to operate its business, especially if the licensed IP is an essential or valuable part of its business operations.

This is a legitimate concern because a licensor in bankruptcy may decide to reject the license as part of its reorganization plan.

Fortunately, the client can rely upon Section 365(n) of the Bankruptcy Code, which mandates that the license remain effective despite a rejection in bankruptcy by the licensor debtor. However, Section 365(n) has its limitations. For example, it does not apply to trademarks or non-U.S. intellectual property rights.

Accordingly, the client may no longer be able to utilize licensed copyrighted materials or patented products from a licensor debtor that has rejected the license if the use of those materials or products are integrally related to the client’s use of a licensed trademark or foreign intellectual property.

In addition, under 365(n) the client also will no longer have the ability to license intellectual property created by the licensor post-petition, and that can seriously damage the client’s ability to do business, especially when the client was expecting continued access to the licensor’s future technology improvements, modifications, updated versions or enhancements, and technical service assistance.

Another major limitation of 365(n) is that a licensee is obligated to make payment on all royalties due under the life of the contract, which means that if payments were also to be made for future technical services (say to upgrade or enhance the licensed technology), the licensee will be paying a super-royalty just for licensing the old intellectual property.

This happens when a license agreement does not distinguish between royalty payments for the license and payments for future services.

Advising Client Licensees

To avoid these negative bankruptcy consequences, licensees are advised to take certain actions before the licensor files a bankruptcy petition.

First, they should draft or amend their existing or prospective license agreements to clearly define and describe the licensed intellectual property and to provide specifically that Section 365(n) will apply to that being licensed.

Second, the licensee should set up a technology third-party escrow arrangement that permits the automatic deposit and transfer of licensor proprietary materials to the nondebtor upon a future bankruptcy filing by the licensor so that the nondebtor (or someone on its behalf) can recreate the licensed technology environment for maintaining operations while also developing any needed upgrades, enhancements or modifications.

Third, the license agreement should break out royalty payments made for the license from payments made for future services. This will help the 365(n) licensee avoid having to pay a royalty premium for services no longer rendered.

Fourth, the licensee should consider taking a security interest in the licensed intellectual property to secure the licensor's obligations and damages in the event of a rejection by the debtor licensor.

Alternatively, the licensee can seek to persuade the licensor to assign the licensed intellectual property to a special purpose or remote bankruptcy vehicle that now functions as the licensor so that the chances of a bankruptcy filing by the licensor are remote.

Finally, there may be ways under certain circumstances to structure (or restructure) the license agreement, making it nonexecutory so that a debtor licensor cannot reject the license in bankruptcy.

When the Client Is the Licensor

When the client is the licensor of intellectual property and the licensee has filed for bankruptcy reorganization, the client may worry that the licensee will assume the license without fully paying, thus making the licensor a low-priority unsecured creditor in bankruptcy for any unpaid amounts.

More important, the licensor may become concerned that the debtor licensee will have the power to assign the license to an unwanted third party, even though the license agreement contains a no assignment without permission clause.

A majority of federal courts has interpreted 365(c) of the Bankruptcy Code as either prohibiting the debtor licensee from assuming a nonexclusive patent or copyright license without first obtaining licensor's permission or, once assumed without permission, from assigning the license to a third party absent permission.

However, there is a split in authority about whether permission from the licensor is first needed to assume and assign to a third party in bankruptcy an exclusive patent or copyright license.

In fact, many courts have held that exclusive IP licenses are freely assignable by the licensee without having to receive licensor's consent, unlike nonexclusive licenses that are often thought of as personal and assignable only with permission from the licensor.

As such, exclusive patent or copyright licensors (compared with nonexclusive licensors) are placed at a much greater risk of having their license assigned without their permission to an unwanted or undesirable third party by the debtor licensee in bankruptcy.

Advising Client Licensors

To avoid any negative consequences of having one's license assigned in bankruptcy to an unwanted third party, especially when an exclusive patent or copyright license has been granted, licensors are advised to draft or amend their existing patent or copyright license agreements to provide for prepetition termination upon well-defined prepetition events signaling that the licensee may be in serious financial trouble.

Such drafting may include a rather onerous automatic termination right, such in the case of a licensee failing to make a single, regular, or routine payment under the license, no matter how much time, effort or resources the licensee previously expended in helping to develop, sell or promote the technology in exchange for receiving an exclusive license to the intellectual property.

However, termination rights in this regard should never be tied solely to the bankruptcy event itself (such as upon the filing of a bankruptcy petition) because ipso facto clauses generally have been held to be unenforceable under the automatic stay provisions of the Bankruptcy Code.

Alternatively, exclusive patent or copyright licensors can draft or amend their existing or prospective license agreements to provide for the automatic conversion of the license, from exclusive to nonexclusive, if a regular or routine royalty or other maintenance fee is not paid by the stated deadline.

Under this more reasonable approach, once exclusivity is lost prepetition, the licensor can then rely upon the available case law that holds that nonexclusive patent or copyright licenses cannot be assumed and assigned in bankruptcy by the debtor licensee without first obtaining permission from the licensor. The licensor can then refuse permission and grant the exclusive license to a more viable entity.

Moreover, if a license agreement was entered into or amended with the automatic conversion provision more than 90 days before the licensee filed for bankruptcy, a licensor may be in a much stronger position to claim that the conversion (even if deemed a “transfer of assets”) is not a “voidable preference” under the Bankruptcy Code because the agreement to convert and the conversion itself were meant to pay off a debt incurred by the debtor licensee in the “ordinary course of business.”

Conclusion

Changes in economic conditions mean changes in business methods. With respect to intellectual property licensing, corporate clients should review and, if necessary, strengthen their past and future licensing practices and agreements to adequately protect their intellectual property rights before a bankruptcy event occurs.

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