Intellectual Property and Bankruptcy

Worlds Collide, But It’s Not As Bad As You Think It Is

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Background on Bankruptcy

- Most common types
  - Chapters 7, 11 and 13
- Chapter 15 – Recognition of foreign proceedings
- Most IP issues arise in Chapter 11 where debtor is licensor or licensee of IP
IP under the Bankruptcy Code

- Not all IP is created equal
- Section 101(35A) defines “intellectual property” as the following
  - A trade secret
  - An invention, process, design, or plant protected under title 35
  - A patent application
  - A plant variety
  - A work of authorship protected under Title 17
  - A mask work protected under Chapter 9 of Title 17
- Note that this definition does not include trademarks, trade names or service marks
  - Licensees of trademarks, trade names and service marks are at risk if licensor files bankruptcy
Treatment of IP under the Bankruptcy Code

- What happens to an IP license agreement if the owner of the intellectual property files a bankruptcy petition
- Is a license agreement an “executory contract”
  - Contract that requires some future or ongoing performance by both parties, where the outstanding obligations for the parties are material
  - **Countryman** test
- Examples of material obligations for executory purposes
  - The obligation of the intellectual property owner to refrain from suing the licensee
  - The obligation of the licensee to account for and pay royalties to the licensor
  - The duty to maintain confidentiality on the part of the licensee
  - The duty on the part of the licensor to indemnify and defend the licensee from infringement claims
- Nonexclusive license agreements – typically considered executory
- Exclusive license agreements – tantamount to sale and non-executory
- Cannot terminate an executory contract during bankruptcy
License Agreements as Executory Contracts

- Section 365 permits
  - Rejection
  - Assumption
  - Assumption and assignment

- Assumption requires the debtor to
  - Cure, or provide adequate assurance that it will promptly cure, defaults (subject to certain exceptions not pertinent to this discussion) under the contract
  - Compensate, or provide adequate assurance that it will promptly compensate, the other party to the contract for any actual pecuniary losses resulting from prior defaults
  - Provide adequate assurance of the debtor’s ability to fully perform all of its future obligations under the contract

- Assignment requires the assignee to provide adequate assurance of its ability to perform all future obligations under the contract
What Happens When a Licensor Rejects an IP License Agreement?

- Section 365(n) provides that if a debtor rejects an executory contract under which the debtor is a licensor of IP, the licensee may either
  - Elect to treat the contract as terminated (i.e., breached), and file a proof of claim for damages flowing from the debtor’s termination of the contract
  - Retain its rights to use the IP under the contract for the duration of the contract and for any extension periods provided for by the contract

- If non-debtor licensee elects to retain its rights to the IP
  - The licensee must continue to make all royalty payments due under the original term of the contract, and any term extensions that the licensee elects to exercise
  - The licensor must, upon written request, comply with contractual requirement to provide the IP to the licensee and must refrain from interfering with the rights of the licensee to the IP

- Hints for licensee
  - Be proactive
  - Do not wait for rejection to exercise Section 365(n) rights
Are Any Protections Given to Trademark Licensees?

- It depends

- Some courts have held that Sections 101(35A) and 365(n) create the inference that Congress did not intend to protect a trademark licensee in the same way in which an IP licensee is protected.

- Other courts reject this “negative inference” and have held that bankruptcy courts have the authority to permit a non-debtor to retain a trademark license based upon the equities of the case.

- The Seventh Circuit rejected the “negative inference” and relied on Section 365(g) to allow the licensee to continue to use the trademark.
  - Section 365(g) provides that a rejection of an executory contract simply constitutes a prepetition breach of that contract.
  - Rejection does not act as either a contract rescission or a termination.

- On February 20, 2019, the Supreme Court heard oral argument in *Mission Product Holdings, Inc. v. Tempnology, LLC*.
  - Court may define protections afforded to trademark licensees in licensor bankruptcy.
What Happens When a Licensee Seeks to Assume an IP License Agreement?

- Contract cannot prohibit its own assignment
- Section 365(c)(1) provides an exception
  - A debtor “may not assume or assign” an executory contract or unexpired lease if “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” and “such party does not consent to such assumption or assignment”
  - “Applicable law” includes patent laws
  - A nonexclusive IP license is personal and not assignable without patent owner’s consent
- Implications of Section 365(c)(1) vary by Circuit and test employed
- Actual test: Licensor cannot prevent assumption unless the debtor-licensee intends to assume and assign
  - Adopted by First and Fifth Circuits and lower courts in Seventh, Eight and Tenth Circuits
What Happens When a Licensee Seeks to Assume an IP License Agreement? (cont.)

- Hypothetical test: Asks if debtor-licensee could hypothetically assign contract over objection of licensor
  - Enormous power to the licensor
  - Adopted by the Third, Fourth, Ninth and Eleventh Circuits

- Footstar approach: Debtor can assume the contract over the objections of the licensor, but a trustee cannot

- Supreme Court has noted the conflict but has not yet resolved the split
Chapter 15 and Foreign Insolvency Proceedings

- Permits U.S. recognition of foreign insolvency proceeding
- What happens if the foreign jurisdiction does not protect IP license rights as per Section 365(n)
- The Fourth Circuit held that Section 365(n) should be applied in Chapter 15 cases to protect a licensee from a foreign debtor-licensor seeking to reject an IP license
Hints and Strategies

- Prior to any bankruptcy filing, review the company’s existing IP license agreements to ensure that the company is protected
- If a bankruptcy is filed, consult with bankruptcy counsel
- If the company is a licensee under an IP license agreement, and if the licensor files
  - Review the agreement and make a determination as to whether it is executory
  - If the agreement is executory, the company must decide whether it wants to retain its rights under the agreement
  - If the company decides to retain its rights under the agreement in accordance with Section 365(n), notice should be sent to the debtor of the company’s decision
    - Need to oppose any motion to reject the agreement
Hints and Strategies (cont.)

- If the company is a licensor under an IP license agreement and the debtor-licensee files
  - Determine if agreement is executory
  - Does company want to object to assumption or assumption and assignment
  - Determine test to be applied

- If negotiating an IP license agreement on behalf of a licensee
  - Ensure that the license agreement specifically provides that the subject of the license agreement is “intellectual property” and that the licensee is entitled to all of the protections afforded licensees under Section 365(n)
  - Negotiate narrowly defined royalty payments and differentiate the royalty payments from other monetary obligations under the agreement
  - Use separate agreements for separate aspects of the transaction
  - Have an SPE hold the IP
  - Negotiate for perpetual, exclusive license
Hints and Strategies (cont.)

- If negotiating an IP license agreement on behalf of a licensor
  - Goals are to
    - Increase licensor’s leverage if the licensee should file for bankruptcy
    - Control the licensee’s ability to assume, or assume and assign, the license agreement (e.g., through choice of law provision or by identifying the specific assignments that should be prohibited)
  - Although the enforceability of such provisions is debatable, it is best practice to include in the agreement limitations on assignability and then to litigate the enforceability of the limitations if necessary
  - Include terms to enhance the licensor’s ability to terminate the agreement before a bankruptcy is filed
    - If the license agreement is terminated prior to the bankruptcy filing, the agreement cannot be revived
    - It will not be part of the bankruptcy estate and therefore cannot be assumed
Mark Salzberg is a partner in the Washington DC office and a member of the firm’s Restructuring & Insolvency practice group. He focuses his practice on bankruptcy litigation, creditors’ rights, debtor reorganizations and complex commercial litigation.

About

Mark has extensive experience representing debtors, creditors’ committees, financial institutions, secured and unsecured creditors, franchisors and distributors in bankruptcy matters throughout the United States. He has served as the lead appellate counsel in multiple bankruptcy appeals at both the district court and bankruptcy appellate panel levels and regularly counsels clients on intellectual property matters arising under the Bankruptcy Code. He is a past member of the Law360 Bankruptcy Editorial Advisory Board.

In addition to his bankruptcy work, Mark has represented parties in a wide variety of complex commercial litigation cases in both state and federal courts, including lender liability suits and other business tort actions, breach of contract, trade secret and noncompete actions.

Before joining Squire Patton Boggs, Mark was a partner at Foley & Lardner LLP. He was a member of the DC Bar Board of Governors from 2014-2015 and a member of the DC Bar Attorney/Client Arbitration Board from 2008-2014.

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