

IP Licenses in Bankruptcy: Navigating the Circuit Split After Tempnology

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

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Introduction

- The economic climate remains uncertain and companies continue to face financial distress, particularly in certain IP-dependent sectors
- Companies in distress may be forced to explore creative alternatives to raise capital and improve liquidity. In a distressed scenario:
 - Licensors may attempt to discontinue existing licenses of important IP rights
 - Licensees may attempt to assign licensed IP rights to third parties without the licensors' consent
 - Distressed IP owners may sell important IP rights
- Recent case law calls attention to the growing discrepancies between the various federal circuits within the U.S., and between U.S. and foreign law, in relation to the treatment of IP licenses in bankruptcy

Topics

- Impact of Bankruptcy Code on IP license agreements (rejection, assumption and assignment, retention of license rights)
 - Treatment of trademarks
- Debtor as licensor
 - Recent court treatment and circuit split
- Debtor as licensee
 - Ipso facto clauses
 - Assumption and assignment
- Cross Border aspects and Chapter 15 filings

The Impact of the Bankruptcy Code on IP Licenses

Impact of Bankruptcy Code on IP license agreements

- With respect to an “executory” contract, a debtor in the US has several options:
 - Assume (debtor cures defaults, honors the contract and continues to perform),
 - Assume and assign (sell the license to any 3rd party that cures defaults and provides performance assurances), or
 - Reject the contract (terminate obligations, create pre-petition damages claim)
- Contractual provisions for termination / modification of rights triggered by bankruptcy filing or financial condition (“ipso facto” clauses) are generally unenforceable
- Section 365(n) provides election for licensees to rejected agreements: treat as terminated or retain rights
- **The key problem when debtor is the licensor:** if a licensor files for bankruptcy and rejects the license, a perpetual license may be insufficient for the licensee
- **The key problem when debtor is the licensee:** contractual provisions for termination / modification of rights triggered by bankruptcy filing or financial condition (“ipso facto” clauses) are generally unenforceable

Are IP Licenses “Executory”?

- A contract will be characterized as an “executory” contract whenever each party still has material unperformed obligations
- In many cases, an IP license can be characterized as an “executory” contract
 - Potential unperformed obligations of licensee: confidentiality, use restrictions, non-challenge, indemnification, quality control, assistance in litigation and prosecution, royalties and reporting, copyright/trademark notice or patent marking
 - Potential unperformed obligations of licensor: confidentiality, forbearance from bringing suit, IP maintenance, no use or licensing (in exclusive license), indemnification, IP maintenance
- *But - Exide Technologies* (3rd Cir. 2010); *Interstate Bakeries* (8th Cir. 2014)
- Licenses executed as part of a broader M&A context

Debtor as Licensor

Circuit Split - Rejection by Debtor-Licensors

- Rejection generally constitutes a breach of the contract by the estate immediately before the petition date (even if a prior breach had not occurred) giving rise to a pre-petition claim for damages to be asserted in the bankruptcy case
- Rejection may enable the debtor-licensor to (i) sell the licensed IP free of the license thus generating a higher price (in fact, most buyers would not acquire the IP if it is encumbered by a broad, long-term license) or (ii) use the threat of rejection to force the licensees to renegotiate a new/amended license with more favorable terms (*e.g.*, higher royalty)
- However, U.S. courts are divided on whether rejection actually terminates the license
 - *Sunbeam Products* (7th Cir. 2012) and other cases: rejection is a breach by the debtor-licensor (relieving the licensor of its obligations) rather than a termination, and the licensee's rights under such contract continue unaffected
 - *Tempnology* (1st Cir. 2018), *Lubrizol* (4th Cir. 1985) and other cases: rejection terminates the agreement and, in the case of an IP license, terminates the licensee's rights thereunder and deprives the licensee of the right to use the licensed IP

§365(n) of the U.S. Bankruptcy Code –Retention of Rights

- Even if rejection leads to termination, §365(n) of the U.S. Bankruptcy Code protects a licensee against loss of rights following debtor-licensor rejection by allowing licensee to elect to (i) treat the contract as terminated (with an unsecured breach of contract claim) or (ii) continue to perform the contract and retain its rights under the licensed IP (subject to payment of the royalties)
- §365(n) was enacted as a direct response to *Lubrizol*
- *Spanston* (3rd Cir. 2012): expansion to covenant not to sue
- However, §365(n) has significant limitations:
 - §365(n) allows retention of passive rights only (no maintenance or support) and excludes rights to post-petition IP (new IP, improvements, upgrades or updates)
 - Licensee must pay all license fees
 - Licensee must make timely §365(n) election, or may lose opportunity if court enforces a deadline requested by debtor
- Uncertainty: trademarks, foreign IP

Treatment of Trademark Licenses

- “Intellectual Property,” as defined in the Bankruptcy Code excludes trademarks
- Legislative history indicates that Congress intended to exclude trademarks from the scope of §365(n)’s protection in order “to allow the development of equitable treatment of this situation by bankruptcy courts”
- Trademark licensing requires the exercise of quality control by the licensor over the licensed products (absent which it may be a “naked license”) because the purpose of a trademark is to identify a good or service to the consumer, which entails a duty to ensure consistent quality
- Some courts (including *Crumbs Bake Shop* (New Jersey, 2014)): §365(n) left open the opportunity for bankruptcy courts to exercise equitable powers to decide whether a trademark licensee retains licensed rights post-rejection
- *SIMA* (Connecticut, 2018): §365(n) applies where the right to use the trademarks was ancillary to the use of other IP and directly embedded within, supplemental to and integral to the IP license
- Other courts: negative inference from the omission of trademarks from the Bankruptcy Code’s definition of “Intellectual Property” - following rejection, the licensee cannot rely on §365(n) for its continue its use of the licensed trademarks

Summary – Rejection by Debtor Licensor

- Circuit split as to whether rejection terminates a contract
- Uncertainty as to what constitutes “executory” contract
- Uncertainty as to whether a trademark licensee may rely on §365(n) to continue to exercise its license rights after the licensor files for bankruptcy and rejects the license
- Additional uncertainties: foreign IP; protection of exclusive rights; bundled contracts
- Solutions for licensors
- Solutions for licensees

Debtor as Licensee

Licensee-Debtor Assumption and Assignment

- **The key problem:** contractual provisions for termination / modification of rights triggered by bankruptcy filing or financial condition (“ipso facto” clauses) are generally unenforceable
- With respect to an “executory” contract, a debtor-licensee in the US may assume (debtor cures defaults, honors the contract and continues to perform) or assume and assign (sell the license to any 3rd party that cures defaults and provides performance assurances) the license
- Right to assume and assign generally overrides anti-assignment clause
- Pre-condition to assumption / assignment: cure of defaults and adequate assurances of future performance
- Licensors cannot compel licensee to assume the contract
- With respect to a non-‘executory’ contract, licensor may have no ability to block debtor-licensee’s continued use of the licensed IP

Protections for Licensor

- Key protection in US Bankruptcy Code: §365(c)(1) prevents licensee assignment of an ‘executory’ contract without licensor’s consent if applicable law requires licensor’s consent for assignment (“applicable law” includes patent, copyright and trademark law)
- US trademark, copyright and patent laws generally prohibit assignment by the licensee of non-exclusive licenses but some exclusive licenses may be assignable without consent
- Some courts do not even allow assumption of the license if applicable law requires licensor’s consent for assignment (on view that reorganized debtor is a new / different entity)
- Can debtor-licensee sublicense to a third party (if the contract so permits)?
- Solutions for the licensor

Cross Border Aspects

Chapter 15 Filings and *Qimonda*

- Foreign debtors may apply to have US courts recognize foreign insolvency proceeding under Chapter 15 of the Bankruptcy Code
- Provides a foreign debtor with US bankruptcy protections for its US assets
- Requires US courts to cooperate with foreign courts (e.g., apply principle of comity to foreign insolvency laws), as long as such actions are not “manifestly contrary” to US public policy (§1506)
- *Qimonda* (4th Circuit, 2014)
 - In Chapter 15 proceedings, where the licensor seeks to reject a license pursuant to non-US law applicable to the main, foreign proceedings, the court is required to conduct a balancing of interests analysis (debtor-licensor vs. creditors-licensees) under §1522(a)
 - In the circumstances of the case, it was necessary to protect the interests of the creditors-licensees under §365(n)
 - Court does not address the bankruptcy court’s other ground for applying §365(n) in Chapter 15 proceedings - that denying §365(n) protection to the licensees is “manifestly contrary” to US public policy

Other Cross Border Uncertainties

- Is §365(n) protection available following rejection of a license to trademarks or non-US IP by a foreign licensor filing in the US under Chapter 15 of the Bankruptcy Code?
 - *Qimonda* concerned US patents
- Is the *Sunbeam* ruling applicable? (*Sunbeam* concerned rejection pursuant to the US Bankruptcy Code)
- Rejection of a license to US or non-US IP by a licensor filing only in a foreign jurisdiction
 - Absence in most jurisdictions of protection equivalent to §365(n) in the event of rejection / termination by licensor
- Termination of a license to a debtor-licensee filing in a foreign jurisdiction
 - In some foreign jurisdictions termination based on licensee's bankruptcy or financial distress may be allowed



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