HOW TO PROTECT YOURSELF AGAINST THE SITUATION WHERE YOUR LICENSING PARTNER FILES FOR BANKRUPTCY AND THEN DECIDES TO "ASSUME" AND "ASSIGN" YOUR TRADEMARK LICENSE

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As the world economy remains mired in a recession, many intellectual property licensors and licensees are considering the question of what to do "if" (and, regrettably, more and more often, "when") their licensing "partner" goes into bankruptcy.[1] Even though the vast majority of license agreements provide for automatic termination of the license in the event that one of the parties (typically the licensee) files a petition in bankruptcy, you may be surprised to learn that such "ipso facto" provisions are generally unenforceable under the U.S. Bankruptcy Code.

Just so there is no confusion about that, let's repeat it—a party to a license typically **cannot** automatically terminate a license agreement simply because its licensing partner has filed a petition in bankruptcy, even though the license agreement expressly so provides.[2]

The reason is simple. The Bankruptcy Code is **not** intended to protect the licensor or the licensee of intellectual property rights. It is intended to: (i) rehabilitate the debtor and provide the debtor with a fresh start; while (ii) maximizing the assets available for making payments to creditors. In order to do this, the Bankruptcy Code seeks to maximize the total assets available to help the debtor reorganize and/or to pay creditors – often taking steps that seem to wantonly trample the rights of intellectual property licensors and licensees.

Of course, neither intellectual property licensors nor licensees are immune from a bad economy. In fact, some of those afflicted by hard times seem unashamedly delighted to look to bankruptcy as a means of shielding themselves from unpaid bills. In the merchandising or character licensing arena it is far more common for licensees, rather than licensors, to go into bankruptcy when times are tough. Conversely, in the technology and software licensing arenas, it is more typical to see a licensor go into bankruptcy, since many licensors are start-ups that are licensing their cutting edge technology and software to some of the largest, and presumably the most stable, corporations in the world.

Bankruptcy in the United States can take a number of different forms. The most common is a Chapter 11 re-organization, where a company seeks protection under the Bankruptcy Code in order to re-organize its business and shield itself from its creditors. Typically, the existing management remains in place. Chapter 7 bankruptcies involve a complete liquidation of the company where the doors are essentially shut. Chapter 13 is typically reserved for the smallest of companies, the type that rarely gets involved in licensing.

For purposes of this presentation, we'll focus on Chapter 11 bankruptcy proceedings and their impact on licensing arrangements.

CHAPTER 11 BANKRUPTCY – CREATION OF THE 'ESTATE'

A Chapter 11 bankruptcy is normally initiated by the filing of a petition by either the debtor company or by a number of its creditors. While the roads leading to bankruptcy can vary, once a petition is filed, they all converge.

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[1] Although we do not address it here, the practitioner also needs to be aware of the situation where the bankruptcy debtor has borrowed money and offered either its licensed rights or its licenses as collateral.

[2] *See* 11 U.S.C. §§ 365(e)(1) and 541(c).

Upon the filing of the petition in bankruptcy under Chapter 11, the Bankruptcy Court assumes jurisdiction, a bankruptcy "estate" is created, and a trustee is appointed to oversee the assets of the estate. Essentially, a bubble is put over the bankrupt company. The estate contains all of the debtor's interests in intellectual property at the moment of filing, as well as the proceeds of such intellectual property interests, and any additional interests in intellectual property which the estate may acquire later.[3] Under Section 362 of the Bankruptcy Code, an automatic stay of (almost) all actions goes into effect upon filing the petition. Thereafter, anyone wishing to proceed against the debtor based on most pre-petition (and some post-petition) events, or even to resume proceedings that already were in progress, must first go through the Bankruptcy Court.

CHAPTER 11 BANKRUPTCY – HANDLING DEBTOR AGREEMENTS

The trustee in bankruptcy will assume control over all agreements to which the debtor is a party. The trustee views these agreements as assets of the debtor. The "type" of agreement will determine which options are available to the bankruptcy trustee

If the agreement is an "executory contract," the trustee will have certain options under Section 365 of the Bankruptcy Code. The term "executory contract" is not defined in the Bankruptcy Code. However, "executory contracts" are commonly understood as contracts "'on which performance remains due to some extent on both sides.'"[4]

Almost all intellectual property license agreements are considered "executory contracts" for purposes of bankruptcy law.[5]

Most patent and technology licenses are deemed to be executory because of such things as the patent and technology owner's obligation to defend and indemnify against claims of infringement and to notify the licensee of infringement actions.[6] Also because of other business terms, such as "most favored nation" clauses (under which the owner-licensor agrees not to give a better rate to a subsequent licensee without giving that rate to the existing licensee), warranties, confidentiality, training and litigation support obligation, and exclusivity clauses.[7]

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[3] *See* 11 U.S.C. § 541.

[4] *NLRB v. Bildisco and Bildisco*, 465 U.S. 513, 522 n.6 (1984), quoting H.R. Rep. No. 95-595 at 347 (1977). The most commonly used working definition of an "executory contract" is the so-called "Countryman definition," also described by some courts as the "material breach" test, which defines an "executory contract" as:

> 'a contract under which the obligation of both the bankrupt and the other party are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.'

Countryman, Executory Contracts in Bankruptcy Law: Part I, 57 Minn. L. Rev. 439, 460 (1973). Whether a contract is executory is measured as of the petition date. Whether the unperformed obligations are material is measured as of the date of the agreement. *See, e.g., In re Exide Technologies*, 340 B.R. 222, 229-30 (Bankr. D. Del. 2006), *rev'd on other grounds,* 607 F.3d 957 (3d Cir. 2010).

[5] *See, e.g., RCI Technology Corp. v. Sunterra Corp.*, 361 F.3d 257 (4th Cir. 2004); *Matter of Buildnet, Inc.*, Nos. 01-82293 et seq., slip op. at 3, 2002 WL 31103235 (Bankr. M.D.N.C. Sept. 20, 2002); *In re Qintex Entertainment, Inc.*, 950 F. 2d 1492, 26 Collier Bankr. Cas. 2d (MB) 143, 21 USPQ 2d 1775, Bankr. L. Rep. Sec. 74396 (9th Cir. 1991).

[6] *See, e.g., In re Szombathy*, 1996 WL 417121 , slip.op. at *7 (Bankr. N.D. Ill. 1996), *rev'd on other grounds*, 1997 WL 189314 (N.D. Ill. 1997).

[7] *See, e.g., Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985), *cert. denied*, 475 U.S. 1057 (1986) (license executory because of licensor's obligation to notify of infringement actions and to grant lowest available rate); *In re Biopolymers, Inc.*, 136 B.R. 28 (D.Conn. 1992) (executory because of exclusivity obligation).

Copyright licenses are generally deemed to be executory as well. This is because the parties will usually have continuing obligations until the license expires, such as the copyright licensor's obligation to indemnify and defend, or to refrain from suing for infringement.[8]

Trademark licenses are almost always deemed to be executory. This is because the licensor has the continuing obligation to monitor quality (absent which the license is a naked license with potentially devastating impact on the validity of the licensed mark), and the licensee has payment and other continuing performance obligations.[9]

Bottom line - Bankruptcy Courts tend to be very “liberal” when it comes to assessing “performance” and will include in such assessment just about anything to achieve the requisite underpinning to a finding that “performance” is still required and thus that the agreement is “executory.” The list of “obligations” that the Court will consider is seemingly limited only by the Court’s (and debtor’s counsel’s) imagination.

When an agreement is found to be “executory,” Section 365(a) of the Bankruptcy Code presents the trustee, on behalf of the debtor and subject to the Bankruptcy Court’s approval, with three options, namely, to: (i) reject; (ii) assume; or (iii) assume and assign; an executory contract.

If the trustee elects the first option, namely, to have the debtor reject the agreement, the agreement will terminate. By rejecting the agreement, the trustee relieves the debtor of future obligations under the agreement. Thus, if the agreement is not particularly advantageous to the debtor, the trustee will reject the agreement, and the debtor will be absolved from future obligations. That doesn’t mean the debtor is relieved of any unpaid past obligations, such as unpaid past due royalties or guarantees. These become debts of the bankrupt estate and are paid out of the proceeds of the bankrupt estate—typically at something less than 100 cents on the dollar.

If, on the other hand, the trustee elects the second option, namely, to have the debtor assume the agreement, i.e., to continue under it, then the trustee must cure any defaults or provide the other party with adequate assurances that it will cure such defaults. The trustee must also compensate the other party for any pecuniary loss to that party as a result of the default or provide the other party with adequate assurances that the trustee will do so promptly. Finally, the debtor must provide the other party with adequate assurances that all future obligations will be met.[10] Stated simply, the agreement continues in effect – as if there were no bankruptcy - and both parties must fully comply with all of the agreement’s terms. Since the Bankruptcy Court is generally pro-debtor, it will typically try to work with the parties and fashion an arrangement whereby any past due monies are paid in accordance with a schedule which it believes that the debtor can achieve. Any such schedule must be agreed to by the other party.

The trustee has yet a third option, namely, to have the debtor assume the agreement and then have the debtor assign the agreement to a third party. Before any such assignment can be effected, however, the intended assignee must provide adequate assurances that it is capable of performing under the agreement.[11]

There are times when the non-debtor party may want the contract to be executory. For example, the non-debtor licensor who wants payment from the debtor-licensee will want the license to be found to be

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[8] *See, e.g., In re Select-A-Seat Corp.*, 625 F.2d 290 (9th Cir. 1980).

[9] *See, e.g., In re Exide Technologies*, 340 B.R. 222, 238 (Bankr. D. Del. 2006); *In re HQ Global Holdings, Inc.*, 290 B.R. 507, 510-11 (Bankr. D. Del. 2003); *In re Travelot Co.*, 286 B.R. 447, 454 (Bankr. S.D.Ga. 2003); *In re Blackstone Potato Chip Co., Inc.*, 109 B.R. 557, 560 (Bankr. D.R.I. 1990); *In re Chipwich, Inc.*, 54 B.R. 427 (Bankr. S.D.N.Y. 1985).

[10] 11 U.S.C. § 365(b)(1).

[11] 11 U.S.C. § 365(f)(2).

executory, since the debtor-licensee is then forced, if it wants to continue to use the licensed content, to assume the license and cure any monetary breach (i.e., to pay the licensor in full).

There are also times when the non-debtor party will want to move the Bankruptcy Court to require that the debtor in an "executory contract" situation make its decision, i.e., whether to assume, reject or assume and assign the license, quickly. For example, a non-debtor licensor will want a quick decision when: (i) there are significant ongoing costs to the licensor; (ii) there are more attractive alternative licensees; (iii) where the licensee lacks the financial resources to fully exploit the license (i.e., to maximize royalty generating sales); and (iv) where there is a risk that the licensee may seek to assume and assign.

The risk that your licensing partner in an "executory contract" scenario may seek to avail itself of the third option, namely, the option to assume and assign its rights and obligations under your license agreement as part of a bankruptcy proceeding, is of greatest concern because of the uncertainty over the third party to whom the agreement will be assigned.

There can be limits on such assignment – although they are not found in the Bankruptcy Code. In fact, the Bankruptcy Code does not identify specific instances when a license may not be assigned.

Indeed, the general rule is that the debtor in bankruptcy may assign an executory contract even in the face of a contractual provision that prohibits or limits assignment.[12]

The Bankruptcy Code does provide, however, that assignment is not permitted in those situations where non-bankruptcy law (statutory or judicial) excuses the non-debtor from accepting performance from an assignee (i.e., in situations where the law will not allow forced assignment of contact rights). Specifically, Code Section 365(c)(1)(A) provides:

> "The trustee may not assume or assign any executory contract … if applicable law excuses a party, other than the debtor, to such contract … from accepting performance from or rendering performance to an entity other than the debtor …"

ASSIGNABILTY OF LICENSES UNDER PATENT and COPYRIGHT LAW

Courts have almost universally held that patent and copyright licenses are not assignable in bankruptcy by a licensee without the licensor's consent, on the grounds that they are deemed to be personal in nature (analogous to "personal service" agreements) and thus contain an implied term restricting assignment.[13] The cases are divided over whether a patent or copyright licensee can avoid the "non-assignment" rule by indirectly "assigning" the licensee's interest in the license, i.e., by selling its stock[14]

Statutory law has also been enacted to help patent and copyright licensees. More particularly, in the case of a bankrupt licensor of trade secrets, U.S. patents and patent applications, plant varieties, U.S. copyrights and U.S. mask works (collectively defined as "intellectual property" by Section 365(n) of the Bankruptcy Code), the issue as noted more fully below is not assignment as much as it is rejection. Happily for the licensees of such bankrupt licensors, Section 365(n) provides them with certain protection. Specifically, notwithstanding the debtor-licensor's decision to reject the license, Section 365 (n) gives to the licensee a specified bundle of rights, including the right to continue to use the licensed intellectual property. Inasmuch as

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[12] 11 U.S.C. § 365(f)(1).

[13] *See, e.g., C.I.R. v. Sunnen,* 333 U.S. 591, 609, 68 S. Ct. 715, 77 USPQ 29, 48-1 U.S. Tax Cas. Section 9230, 36 A.F.T.R. Section 611 (1948); *Harris v. Emus Records Corp.,* 734 F. 2d 1329, 222 USPQ 466 (9th Cir. 984); *In re Patient Educ. Media, Inc.,* 210 B.R. 237, 31 Bankr. Ct. Dec. 49 (Bankr. SDNY 1997); *Sony Corp. of America v. Universal City Studios, Inc.*, 464 U.S. 417, 429, 104 S.Ct. 774, 781, 220 USPQ 665 (1984).

[14] The outcome will depend upon whether the court applies what is called the "hypothetical test" or the "actual test" – but that is a topic beyond the scope of this presentation.

Section 365(n) gives significant benefits to licensees, they should make every attempt to make sure that they are able to take advantage of such benefits. To that end, licensees should make sure that the license: (i) explicitly references the statute; (ii) describes the licensed content in the terminology of the statute; (iii) states that the provisions of Section 365(n) apply should the licensor apply for bankruptcy; and (iv) clearly define performance obligations required of the licensor and spell out that the failure of the licensor to perform such obligations constitutes a material breach excusing performance of the licensee (i.e., the license should recite the elements the Court needs to find under the "Countryman standard" in order to deem the license to be "executory").

ASSIGNABILTY OF LICENSES UNDER TRADEMARK LAW AND THE CASE OF *In re: XMH Corp.*

For years, it has been unclear as to whether, under trademark law as interpreted by judicial opinions, trademark licenses are assignable. It was suggested in dictum in a bankruptcy case in 2002 that trademark licenses were non-assignable.[15] And that dictum became the basis for two district court cases.[16] But, prior to this year, no Court of Appeals had addressed the subject.

And, unfortunately, statutory laws have been unavailing. Licenses of trademarks, as well as licenses of technology or content that is not protected by U.S. patent or copyright law, and of some database compilations – were **not** provided with statutory protection under Section 365(n) of the Bankruptcy Code.

On July 26, 2011, the Court of Appeals for the Seventh Circuit addressed the question of whether a trademark license can be assumed and assigned by the debtor-licensee without the licensor's consent.[17] The salient facts of the case are as follows:

- Hartmarx Corporation (which later changed it names to XMH) filed a Chapter 11 bankruptcy.

- Licensee-Simply Blue, a subsidiary of XMH which was also in bankruptcy, sought to sell its assets, including an executory contract with Western Glove Works, to the purchasers – but Licensor-Western objected. The basis for the objection was that the license was actually a sub-license. The Bankruptcy Court agreed with Western and disallowed the assignment. XMH appealed.

- During the pendency of the appeal, Simply Blue and the purchasers amended the contract so that Simply Blue retained title in the contract, but the purchasers assumed all of Simply Blue's obligations under the contract, as well as Simply Blue's right to fees. The Bankruptcy Court approved the amendment, and Western appealed.

- In the meantime, the district court reversed the Bankruptcy Court's original decision, holding that the contract could be assigned, and Western appealed that decision, too.

The Court of Appeals looked to Section 365(c)(1) of the Bankruptcy Code which limits assignment of an executory contract if "applicable law" permits the non-debtor to the contract to refuse to accept performance from an assignee, regardless of whether the contract prohibits or restricts assignment.[18] The contract at issue neither prohibited, nor restricted assignment. Western argued that "applicable law" was trademark law, because

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[15] *In re Travelot Co.,* 286 B.R. 447 (Bankr. S.D. Ga. 2002).
[16] *In re NCP Mktg. Group, Inc.,* 337 B.R. 230 (D. Nev. 2005); *In re Wellington Vision, Inc.,* 364 B.R. 129 (S.D.Fla. 2007). Note – the Nevada District Court's decision in NCP Mktg. was affirmed in an unpublished decision of the Ninth Circuit Court of Appeals.
[17] *See In re XMH Corp.,* 2011 WL 3084926 (7th Cir. 2011).
[18] *In re XMH Corp.,* at *3

the contract stated that Western, which was a licensee of the trademark "Jag Jeans", granted Simply Blue a license (really, a sublicense) to sell women's jeans wear bearing that mark.[19] The Court of Appeals agreed, and then turned its attention to whether, under trademark law, a licensor may refuse to accept performance of a license agreement by an assignee.

The Court recognized that a trademark owner "will not want [his] licensee to be allowed to assign the license (that is, sublicense the trademark) without the owner's consent, because while the owner will have picked his licensee because of confidence that he will not degrade the quality of the trademarked product he can have no similar assurance with respect to some unknown future sublicensee."[20] **As a result, the Court held that a trademark license is not assignable in the absence of a provision expressly authorizing assignment.[21] Lest one wonder whether the Court was serious about its holding, the Court described the rule as a "universal rule"[22] which should be considered a "default rule"[23] of contract law**.

Unfortunately for Western, at the time Simply Blue purported to assign the contract to the purchasers, the trademark sublicense contained in the contract had expired. Given that the contract was no longer a trademark license, the Court's fervently endorsed "default rule" was inapplicable, and nothing prevented the contract from being assigned without Western's consent.

There are steps that can be taken to help avoid the undesirable scenario where the debtor seeks to assume and assign a license – regardless of the type of intellectual property involved - which is the focus of the rest of this presentation.

PROVISIONS IN A LICENSE AGREEMENT THAT CAN PROTECT LICENSORS

The smart intellectual property owner recognizes that the traditional termination provision ostensibly triggered by the filing of a petition in bankruptcy is generally unenforceable. That owner will include certain additional provisions in its license agreements that will give it some leverage should a licensee seek protection under the bankruptcy laws, to wit:

1. Keep your license agreements relatively short. A license that is supposed to expire by its own terms is unaffected by the filing of a petition in bankruptcy prior to expiration. The automatic stay has no effect. At the end of the license term the license will terminate. If you include options to renew in the agreement, ensure that they are conditioned upon the licensee meeting certain financial conditions and otherwise being in full compliance with the terms of the license agreement.

2. Include termination provisions based on deteriorating financial conditions that generally occur in advance of the filing of a petition in bankruptcy, e.g., failing to meet financial obligations when they become due, making assignments for the benefit of creditors, entering into forbearance agreements with creditors or lenders, exceeding an agreed-upon debt limit, having a judgment rendered against it in excess of a specific amount, failing to provide adequate assurance of its ability to meet future obligations as may be required under the UCC. Then, when circumstances make it appropriate, **immediately** act on those termination provisions. Once the licensee files for bankruptcy, these added safeguards will be of no use to you. In fact, if the licensee later files for bankruptcy, a termination based

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[19] *Id*.

[20] *Id*. at *5.

[21] *Id*. at *4

[22] *Id*.

[23] *Id*. at *5.

on one of these insolvency-related grounds may not be enforced in the bankruptcy proceeding, thus allowing the licensee to "recapture" and retain the rights under the contract, including the right to assume or assign the license agreement during the bankruptcy case.

3. Include personal services provisions in the license agreement, e.g., require the design services of certain key designers, etc., to thereby potentially limit the assignment of an agreement by a bankrupt licensee since personal services contracts are typically not assignable and a potential assignee may not necessarily be in a position to provide the necessary assurances that it is capable of complying with such provisions.

4. Include anti-assignment provisions with respect to an assignment to competitors of the licensor or other potential undesirable entities, recognizing that agreements that are otherwise assignable by law will generally remain assignable.

5. Seek security for guarantees due under the agreement by having the licensee execute a security agreement in the amount of the unpaid guarantees secured by the inventory of the licensed products and then make sure that appropriate UCC-1 forms are filed with the appropriate governmental officials.

PROVISIONS IN A LICENSE AGREEMENT THAT CAN PROTECT LICENSEES

In truth, the major concern of the licensee is NOT that the licensor will assign the license agreement to a third party. Rarely will such action have any "real world" consequence to the licensee.

The greater concern to the licensee is that the licensor will reject the license and grant a new license to someone else.

The rights afforded a debtor-licensor under the Bankruptcy Code give the debtor-licensor an enormous economic advantage over the licensee – particularly in those situations where the licensed content does not fall within the scope of "intellectual property" and Code Section 365(n). The debtor-licensor can threaten to reject the license unless the licensee is willing to renegotiate the terms of a license. The debtor-licensor can pick and choose amongst licensees in connection with a sale of the licensed property, i.e., assigning only certain licenses to the buyer and rejecting the rest. Or the debtor-licensor can reject all existing licenses and start afresh.

There is little that a licensee can do to protect itself in such circumstances if the licensor intends to assign the license agreement. Certain provisions that a licensee can include in its license agreements that will give it some leverage should a licensor seek protection under the bankruptcy laws are:

1. Provisions specifying whatever the performance is that is expected of the licensor.

2. Provisions that reflect the substantial investment required of the licensee to effectuate the license – with the hope that, if called upon to weigh the equity of allowing rejection by the debtor-licensor, the Bankruptcy Court will conclude that allowing rejection would be inequitable, i.e., the benefits to the debtor-licensor are far outweighed by the detriment (damage) to the licensee.[24]

3. Seek security for performance obligations due under the agreement by having the licensor execute a security agreement in an agreed upon amount, secured by the licensed intellectual property and other assets associated with the intellectual property, and then make sure that appropriate UCC-1 forms are filed with the appropriate governmental officials.

[24] *See In re Petur U.S.A. Insurance Co.*, 35 B.R. 561 (Bankr. W.D. Wash. 1983).

CONCLUSION

Financial experts have been saying for months that we are navigating "uncharted waters" with respect to the economy. Parties to license agreements would do well to heed this warning and take appropriate steps in connection with their license agreements and licensing practices to minimize the potential for damage from an unexpected and unwelcome assignment of their license agreement.