When Licensor's Reject:

How to Protect Licensees of Intellectual Property

By Adam L. Rosen

BANKRUPTCY Code Sec. 365(n), the knight in shining armor for licensees of intellectual property, was left unscathed by the Bankruptcy Reform Act of 1994. Before the enactment of Sec. 365(n) in 1988, the protections afforded to licensees of intellectual property when the licensor filed a bankruptcy case were highly uncertain. This article examines the rights of such a licensee of intellectual property before the enactment of Sec. 365(n), how those rights were changed by 365(n) and the impact of the U.S. Court of Appeals for the Ninth Circuit's recent decision in *In re Prize Frize, Inc.*, 32 F.3d 427 (9th Cir. 1994), regarding what constitutes "royalty payments" as referred to in Sec. 365(n). Finally, we suggest drafting guidelines for intellectual property licenses to enhance protection for the licensee upon the licensor's rejection of the agreement.

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Perhaps the most notorious example of a court's treatment of an intellectual property licensee prior to the enactment of Sec. 365(n) is *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985). In *Lubrizol*, Richmond Metal Finishers (RMF), the owner and licensor of a metal coating process technology, filed a petition for relief under Chapter 11. Pursuant to Code Sec. 365, RMF sought to reject its non-exclusive license of the metal coating process technology to Lubrizol Enterprises.

The bankruptcy court applied the business judgment test, determined that the rejection met the requirements of the test and authorized RMF's rejection of the license. Its decision was reversed by the district court, which was, in turn, reversed by the 4th Circuit.

Continued on Page 4

Two Courts Apply Reform Act to Pending Cases

Continued from preceding page

One area where courts in cases pending prior to the effective date might rely on the Reform Act, instead of existing case law, is when deciding whether unsecured creditors of a solvent debtor are entitled to receive interest on their claims. The Reform Act provides that such creditors are deemed impaired unless they receive payment in full on their claims and post-petition interest on such claims. This provision reverses a recent bankruptcy court decision, *In re New Valley Corp.*, 168 B.R. 73 (Bankr. D.N.J. 1994), where the court held that unsecured creditors of a solvent debtor were not impaired and therefore not entitled to receive post-petition interest on their claims.

Another area where courts in pre-effective date cases may be guided by the Reform Act, as opposed to existing case law, is the "hotel room receipts" question. The legislative history of the Reform Act states that it was intended to clarify that revenues generated from the use and occupancy of hotel rooms constitute the hotel financier's cash collateral in the hotel operator's bankruptcy.

These amendments reverse the line of cases where courts have held that room revenues are not "rents" and are therefore not included in the Bankruptcy Code's cash collateral scheme. *See, e.g., In re Punta Gorda Assocs.*, 137 B.R. 535 (Bankr. M.D. Fla. 1992).

Other sections of the Reform Act that courts in cases started before the effective date may view as more influential than existing case law include those which provide that (a) a secured creditor need not have enforced its security interest in the debtor's rents (e.g., by obtaining the appointment of a receiver) prior to the petition date in order to maintain such interest post-petition, and (b) a tenant's leasehold rights (including rights to use, sublease and assign) are not extinguished upon the debtor-landlord's rejection of the subject lease.

Limitations

However, there may be several limitations to the general applicability of the Reform Act to cases commenced prior to the effective date. First, in *Pereira* and *Schwartz*, there was no clear controlling authority on point. Where the relevant section of the Reform Act conflicts with binding precedent, courts may be hard-pressed to rule based on the Reform Act.

Second, courts may be more likely to seek guidance from the Reform Act where it was intended to clarify, rather than alter, an existing Code section. The *Pereira* court and, in pertinent part, the *Schwartz* court, concluded that the Reform Act merely clarified the intent of the drafters of the prior Code sections and could therefore be used in interpreting such sections. However, where the Reform Act clearly alters an existing Code section, courts in cases filed prior to the effective date may render decisions directly contrary to the Reform Act in an effort to comply with the intent of the drafters of the existing Code section.

It remains to be seen the extent to which the courts will be guided by the Reform Act in cases commenced prior to the effective date. However, the above decisions may prove instructive to courts faced with these and similar issues. ■

How to Protect Licensees of Intellectual Property

Continued from Page 3

In restoring the decision of the bankruptcy court, the Fourth Circuit defined the business judgment test as "whether the decision of the debtor that rejection will be advantageous is so manifestly unreasonable that it could not be based on sound business judgment," but only on bad faith, whim or caprice. Pursuant to Sec. 365(g), the rejection constituted a breach of contract entitling Lubrizol to an unsecured prepetition claim for any damages suffered. See 11 U.S.C. § 365(g). The Fourth Circuit would not permit Lubrizol to continue to use the technology, even if specific performance would be an available remedy upon breach of this type of contract.

Enactment of Sec. 365(n)

A licensee's unsecured damage claim for rejection of a license is a drastically inadequate remedy because the licensee may have invested substantial amounts in reliance upon its rights under the license and may receive little or nothing as an unsecured creditor. In response to widespread industry concern over *Lubrizol*, Congress enacted the Intellectual Property Bankruptcy Protection Act, Pub. Law No. 100-506 (1988), which added Sec. 365(n) to the Bankruptcy Code. Sec. 365(n) became effective Oct. 18, 1988, and is not applicable to cases filed before that date.

Sec. 365(n) applies to executory contracts under which the debtor is a licensor of a right to intellectual property. Intellectual property is defined under Sec. 101(35A) as: "(A) trade secret; (B) invention, process, design, or plant protected under title 35; (C) patent application; (D) plant variety; (E) work of authorship protected under title 17; or (F) mask work protected under Chapter 9 of title 17; to the extent protected by applicable nonbankruptcy law." The legislative history to Sec. 365(n) indicates that it is inapplicable to licenses of trademarks. S. Rep. No. 100-505, 100th Cong., 2d Sess. 36 (1988), *reprinted in* 1988 U.S.C.C.A.N. 3200, 3204.

Sec. 365(n) provides that, upon a debtor licensor's rejection of an executory contract which licenses a right to intellectual property, the licensee may react in one of two ways. First, the licensee may view the licensor's rejection as a termination of the agreement if such rejection is a breach that would entitle the licensee to treat the contract as terminated.

Second, the licensee may elect to retain its rights under the contract as they existed immediately before the case commenced. This second option permits the licensee to continue to utilize its rights under the terms of the contract for the duration of the contract, including a right to enforce any exclusivity provisions under the agreement.

Once the licensee opts to retain its rights under the agreement, certain obligations are imposed on the licensee. First, the licensee must "...[m]ake all royalty payments due under such contract...." 11 U.S.C. § 356(n)(2)(B). Second, the licensee is deemed to waive "(i) any right of setoff it may have with respect to such contract under this title or applicable nonbankruptcy law; and (ii) any claim allowable under Sec. 503(b) of this title arising from the performance of such contract." U.S.C. §§ 365(2)(C)(i) and (ii).

Thus, under the second option, a licensee may use the license but must continue to pay royalties and may not setoff against its royalty obligations claims it may have against the debtor with respect to such contract. In addition, any claims it may have against the debtor will not be allowable as administrative expenses under Sec. 503(b).

Royalty Payments

The meaning of the term "royalty payments" contained in Sec. 365(n)(2)(B) was recently defined by the Ninth Circuit in *Prize Frize*. Prize Frize Inc. (PF) was the owner and licensor of technology utilized in the manufacture and sale of a french fry vending machine. PF and Encino Business Management (EBM) were parties to an agreement that granted EBM an exclusive license to use the technology.

Shortly after PF filed its Chapter 11 petition, EBM ceased payments under the license agreement due to an alleged defect in the machines. PF then rejected the agreement pursuant to Sec. 365. EBM elected to retain its

Continued on following page

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Drafting Possibilities to Benefit Licensees Under Licensor Bankrutptcy

ANALYSIS of the language contained in Sec. 365(n) and the *Prize Frize* decision suggest a number of drafting possibilities that could be beneficial to a licensee when the licensor enters bankruptcy.

First, Sec. 365(n) protects licensees' right to "intellectual property" pursuant to an executory contract. Thus, if it is intended that Sec. 365(n) be applicable, the license agreement clearly should establish that the agreement is an executory contract, i.e., one in which substantial continuing obligations exist for each party to the agreement over the life of the contract.

Second, the subject matter of the agreement must constitute "intellectual property" as that term is defined in Secs. 101(35A) and (39). Thus, it is useful to recite in the agreement that the agreement is governed by Sec. 365(n) of Title 11, U.S. Code and that the subject matter of the contract constitutes intellectual property within the meaning of Secs. 101(35A) and (39). Although this will not guarantee that the contract encompasses intellectual property, it may serve as an admission by the licensor in potential future litigation.

Third, upon the debtor-licensor's rejection of the contract, the licensee who elects to retain rights is required, pursuant to Sec. 365(n)(2)(B), to make "[r]oyalty payments...for the duration of such contract..." which are not subject to setoff. 11 U.S.C. § 365(n)(2)(B)(C). Thus, the licensing agreement should specify what portion of the licensee's payments represent royalty payments and what portion, if any, represent payments for maintenance, support and other services as to which the licensee may be able to reduce such payments to the extent that the debtor fails to furnish such maintenance, support or services.

Fourth, Sec. 365(f) allows the trustee or debtor to assign an executory contract to a third party if the assignee assumes the contract and provides "adequate assurance of future performance." 11 U.S.C. § 365(f)(2)(B). This term is not defined in the Bankruptcy Code and courts have failed to specify whether an assignee to a contract must assume all of the debtor's obligations. Therefore, in order to protect a licensee, the licensing agreement should define what will constitute "adequate assurance of future performance" if the contract is assigned by the licensor to a third party. The problem of adequate assurance may be resolved by requiring the assignee to perform all of the duties imposed upon the debtor-licensor under the agreement. In addition, the agreement may specify that the assignee satisfy certain net worth or other capital requirements to ensure that maintenance and development obligations under the agreement are satisfied.

Although these provisions will not be binding upon courts, they should, at the least, provide evidence of the parties' intentions and provide guidance in determining the obligations and qualifications of an assignee. — *Adam L. Rosen*

How to Protect Licensees of Intellectual Property

Continued from preceding page

rights to the license in accordance with the provisions of Sec. 365(n)(2)(B), but claimed that it was not required to pay "license fees" to PF but only those amounts referred to as "royalties." The issue presented was what portion of EBM's payments to PF constituted "royalty payments" that EBM was obligated to pay pursuant to Sec. 365(n)(2)(B).

EBM argued that the terms of the agreement defined the portion of required payments allocated to license fees and the portion of payments allocated to royalties. The court, however, determined that "[t]he parties by their choice of names could not alter the underlying reality nor change the balance that the Bankruptcy Code has struck" and concluded that all payments owed by EBM for use of the license were "royalty payments" within the meaning of Sec. 365(n)(2)(B). The court reasoned that "[d]espite the nomenclature used in the agreement, the license fees paid by EBM are royalties in the sense of Sec. 365(n)... 365(n) speaks repeatedly of 'licensor' and 'licensee' with the clear implication that payments by licensee to licensor for the use of intellectual property are indifferently 'licensing fees' or 'royalties.'" Legislative history supports the court's interpretation. H.R. Rep. No. 1012, 100th Cong., 2d Sess., at 9 (1988).

Striking a Balance

The enactment of Sec. 365(n) provided much needed protection for licensees of intellectual property in bankruptcy cases. 365(n) attempts to strike a balance between the needs of the debtor-licensor and the licensee. However, Sec. 365(n) is applicable solely to executory contracts licensing a right to "intellectual property" as that term is defined under Secs. 101(35A) and (39). By carefully drafting license agreements to afford the full protections of Sec. 365(n) to the licensee, a reasonable balance of power between licensors and licensees in bankruptcy cases can be maintained. ■

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