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Incorporating IP Asia

Reducing the Effects of Licensing Bankruptcy

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Reprinted from the July/August issue 2004

Reducing the effects of licensing bankruptcy

The close relationship between parties in licensing agreements leaves companies vulnerable if their partners go broke. Karen Artz Ash and Bret J Danow provide 10 tips for navigating the US bankruptcy minefield

In today's global high-stakes marketplace, companies generate revenue and capitalize on their brands and other proprietary rights through licensing. However, when one of the licence parties files for bankruptcy, the impact on the other can be catastrophic. In addition to knowledge of the US Bankruptcy Code, there are some tools that an attorney or business person can use to minimize the impact of the other party's bankruptcy.

The consequences of bankruptcy on those in a licensing agreement are so pronounced because the parties are in some ways inextricably tied. While a licensor can expand its renown to goods that it cannot or does not manufacture or sell itself, it does so by relying upon the reputation and business acumen of a third party, leaving the fate of the licensor's name, goodwill, and proprietary rights in unrelated hands. On the other hand, a manufacturing or marketing company that occupies a unique distribution or other speciality niche often builds its business as an authorized user or licensee of another party's brand and other proprietary rights. All, or substantially all, of the licensee's business as a going concern may rely on its ability to use the licensor's trade mark or other licensed property.

In short, the fate of the licensor and the licensee are interdependent. Each, to a significant extent, relies on the good standing of the other, both rely on the value of the IP, and each can affect the value and integrity of the property as well as the fiscal health of the other party. All of these interdependent relationships are governed by the written licence agreement, and both the licence and the parties are affected by their interaction with the US bankruptcy laws.



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The Bankruptcy Code

Under Section 365(n) of the US Bankruptcy Code (known as the Code), "intellectual property" is defined expressly to include patents and copyrights, but does *not* include trade marks. Presumably, this is because trade mark licensing agreements depend in part on control of the quality of the products or services sold by the licensee. In particular, trade mark owners who license rights in a particular mark must play an active role in approving the quality of products bearing the licensed mark. This affirmative duty on the part of the licensor purportedly conflicts with Section 365(n) of the Code which, in allowing for an election by a licensee to continue using a licensed property post-bankruptcy, permits the debtor to use the licensed property free from the obligations set forth in the licence agreement.

Because trade marks are not included in the Code's definition of "intellectual property," certain protections provided by the Code for parties to a patent or copyright licence agreement, as



described below, are not applicable to trade mark licence agreements. Consequently, when a trade mark licensor petitions for relief under the Code, it can reject the entire trade mark licence agreement pursuant to existing US bankruptcy law, thereby terminating the licensee's right to use the licensed name, mark and related property. This termination of rights can often be devastating to a licensee because it is left with only a pre-petition claim for damages, and the remedy can fall far short of the actual financial injury that a licensee may suffer. Similarly, when a licensee petitions for relief, it too can reject the licence agreement, leaving the licensor in the unfortunate position of having only a pre-petition claim for damages and having to scramble to find a successor licensee.

Whenever possible, trade mark licence agreements should attempt to accommodate these potential consequences (depending upon whether the drafter is representing a licensor or licensee). At a minimum, they should be mindful of the impact that US bankruptcy laws may have on their client's ability to continue to use the licensed property (or assign the rights to do so) should one party to the agreement file for bankruptcy protection. Most often, standard provisions included in trade mark licence agreements to protect a licensor's interests, for example, are simply unenforceable.

Ways to minimize risk

There are some steps that an attorney or business person can take to minimize the risk. First, they should examine how the Code

affects IP licence agreements (and trade mark licence agreements in particular), and then use the 10 methods described below as they draft their agreements to position their clients optimally.

Licence agreements are executory contracts under the US Bankruptcy Code

Any licence (including trade mark licences) of IP rights is considered to be an "executory contract" under the Code. In other words, it is a contract in which the obligations of both parties to the contract "are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other". Section 365 of the Code provides that, on the filing for bankruptcy of any party to such an agreement, executory contracts are subject to a trustee's (or debtor-in-possession's) option to reject or assume them. The trustee in bankruptcy or the debtor-in-possession may elect to reject the licence and seek to terminate it, or assume the licence by (1) curing or providing adequate assurance of cure, (2) compensating or providing adequate assurance of compensation for actual pecuniary loss resulting from the default, and (3) providing adequate assurance of future performance under the contract.

Rejection of a licence agreement

When a trustee in bankruptcy or debtor-in-possession in a licensor's bankruptcy proceeding seeks to reject a trade mark licence

agreement, the licensee can treat the debtor-licensor's rejection of the licence as a breach of the agreement, and seek damages by filing a proof of claim in the Bankruptcy Court. If the licensee does not have a security interest in the licensed trade mark, seeking damages in this way would be the licensee's primary, if not exclusive, recourse.

The Bankruptcy Code grants a non-debtor licensee certain protections with respect to patent and copyright licences, namely assuring the licensee of a patent or copyright that it will be entitled to retain and use the licensed IP, regardless of whether the licence agreement is rejected. Section 365(n) of the Code provides that, if the trustee or debtor-in-possession rejects an executory contract under which the debtor is a licensor of a right to "intellectual property," the licensee may elect either to treat such a contract as terminated or retain its rights to the licensed IP (patent or copyright rights) under the contract (provided that it continues to make all royalty payments due under the contract for the duration of the contract).

If the debtor-licensor rejects the contract and the licensee elects to retain the rights, such election must be made pursuant to a formal, written demand. The rights retained by the non-debtor licensee may not exceed those rights in existence at the moment before the licensor's filing for bankruptcy. In other words, there is no surviving right to upgrades, improvements, completed prototypes or finished products after the bankruptcy filing. The licensee who seeks specific protections to continue to use licensed copyrights or patents will not have the rights to rely on or exploit expansions or other attributes of the licensed property that would otherwise require additional performance or value by the debtor-licensor. In this connection, such a licensee may not be entitled to retain the benefits of other aspects of the licence agreement that require licensor's performance and further services such as design services, technical support and indemnities.

The election by a licensee to retain rights to use the "intellectual property" after rejection also affects an automatic waiver of any common law setoff rights. Therefore, even if the debtor-licensor owes the licensee money or other consideration, the licensee cannot deduct owed amounts or their attributed value from the royalty payments due under the licence agreement. At best, a licensee of a retained "intellectual property" right has the right to assert a general, unsecured pre-petition claim for damages for the money it is owed by a licensor.

Trade mark licence agreements, unlike copyright and patent licences, are not subject to the post-rejection protections provided under Section 365(n) of the Code and, therefore, drafters need to be far more conversant with the Code and more creative in fashioning protective clauses. The following recommendations are, at a minimum, a step toward protecting the non-debtor party to a trade mark licence agreement (either to assist in securing continuity of rights for a licensee if a licensor files for bankruptcy; or to minimize the assignment of rights to a third party and damage to the brand where the licensee files for bankruptcy protection).

Licensing in the fashion industry

The interaction between the US Bankruptcy Code and trade mark licence agreements is of particular concern to companies in the fashion industry because these companies are exceptionally dependent on licensing relationships.

Many large design houses do not manufacture products themselves and therefore rely on licensing third parties. The value of a famous brand may therefore rest in the hands of a licensee and be captive to the failures of that licensee's business as a whole. If the trade mark licence agreement does not at least attempt to safeguard the licensed asset in the event of licensee's bankruptcy, the value of licensor's brand, property, reputation and integrity could be compromised. Similarly, many apparel manufacturers, distributors and sellers rely entirely on their continued ability to manufacture and sell particular products bearing someone else's name, brand or property rights.

If the licence agreement does not do whatever is possible to preserve the licensee's ability to continue to use the asset in the event that the licensor files for bankruptcy, the non-debtor licensee's business could be destroyed or, at a minimum, have its value greatly diminished.

1) Provide for required prior written notice of bankruptcy filing

Although it is left to the discretion of the Bankruptcy Courts to determine whether an executory contract should be rejected in view of a licensee's rights under Section 365(n), that very section dictates what happens to the licence agreement *after* it has been rejected. Prior to rejection, Section 365(n) serves as a guide to determine whether the Bankruptcy Court should approve rejection of an executory contract. Once rejection is approved however, Section 365(n) gives the Bankruptcy Court little leeway to fashion equitable relief to minimize the damaging effects to a licensee once it has approved the licensor's rejection of the agreement. Therefore, to protect its rights, a licensee must assert its rights early in the licensor's bankruptcy case, before the licensor receives court approval of a decision to reject the agreement. Specifically, a licensee must intervene prior to the rejection of the licence agreement by persuading the Bankruptcy Court that rejection should not be approved because equity dictates that the trade marks are integrally linked to the property.

In circumstances where a licensee is the debtor, the licensor-brand owner would also benefit from early written notice so that it can take appropriate steps to intervene if the trustee or debtor-in-possession seeks to assume the licence and sell or assign the rights to another party (as it may be permitted to do, under the protections of the Code). The non-debtor licensor would also be interested in ensuring that the level of quality for the products can be retained in the face of financial constraints.

Because timing is critical, the interests of both parties are well served if the licence agreement requires each party to notify the

other in writing *prior* to its filing for bankruptcy. This notice will ensure that there is sufficient time for the non-debtor party to intervene in the Bankruptcy Court proceedings prior to the approval of rejection of the licence agreement by a licensor, or assumption and assignment by a licensee. This time benefit might also facilitate participation in a pre-packaged bankruptcy, if that is likely to happen, working in conjunction with the licensor's other creditors.

2) Provide a roadmap to the trustee in bankruptcy or court

Drafters can attempt to provide a roadmap to the trustee in bankruptcy or the Bankruptcy Court about how to treat the licence agreement by including language in the agreement that includes the trade mark licence within the purview of Section

A licensee must assert its rights early in the licensor's bankruptcy case

365(n) of the Code. This might be accomplished by expressly stating in the licence agreement that the parties expressly and mutually acknowledge that the licensed property constitutes "intellectual property" under the Code, and that the agreement should be governed by Section 365(n) of the Code in the event that licensor files for bankruptcy. Alternatively, counsel for a licensee can attempt to come within the purview of Section 365(n) by incorporating provisions describing that the licensed trade mark is integrally linked to other licensed and protected IP such as, for example, copyrighted designs. Although such provisions are certainly not absolute and are not binding upon the court or trustee, it articulates the parties' intentions at the time they entered into the agreement and can serve to define the equities and relative rights of the parties in the event that termination or rejection is elected.

3) Separate different types of payments to the licensor

Many trade mark licence agreements are structured so that the licensor provides design and/or consulting services to the licensee in connection with the design of products bearing the licensed trade mark. In such circumstances, in addition to trade mark royalties, the licensee may pay the licensor a separate fee in exchange for licensor's design or consulting services. The structure of payments of design fees and royalties may be relevant when interpreting how the licence relationship and licensed property, as a whole, will be treated by the Bankruptcy Court.

The Code requires the non-debtor licensee electing to retain its rights in the IP licence agreement to continue to make all royalty

payments due under the contract. The Code interprets the term "royalties" broadly to include all fees payable under the agreement. Therefore, if the fee arrangements are structured so that the payment to the licensor for any design services are stated separately from the payment of royalties for the use of the trade mark (or set forth in a separate design services agreement), a licensee attempting to elect to continue its rights under Section 365(n) could minimize the chance of finding itself in the position of paying for services that it will no longer receive.

4) Benefits of other services do not continue post-bankruptcy

As indicated above, a licensee electing to retain its rights in the covered IP is not entitled to retain the benefits of other aspects of the licence agreement requiring continued support, services, and performance by the debtor-licensor. Therefore, if the licensee requires the continued services or support of a debtor-licensor in order to create, manufacture or develop the line of licensed products, it may elect not to retain the licence agreement unless it has secured other rights to look to different sources for the same services or support.

For example, a non-debtor licensee may need to hire third party vendors, manufacturers and/or distributors to perform various tasks previously provided by the licensor under the agreement. Thus, the drafter with the objective of protecting the licensee in the event of a licensor's bankruptcy should ensure that the licence allows the licensee to provide the licensed property to the necessary third parties to secure alternative support or services without violating any exclusivity or confidentiality provisions of the licence.

5) *Ipsa facto* clauses are unenforceable

An *ipso facto* clause in a licence agreement is one that effects an automatic termination or other consequence when a certain event occurs, often the filing for bankruptcy. Standard form licence agreements almost always include clauses which allow the licensor to terminate the licence agreement, or effect an automatic termination in the event the licensee files a petition in bankruptcy, is adjudicated a bankrupt, becomes insolvent, makes an assignment for the benefit of creditors files a petition or otherwise seeks relief under or pursuant to any bankruptcy, insolvency or reorganization statute or proceeding. However, Section 365(b)(2) of the Code holds that a default giving rise to termination is not a breach of a provision relating to (1) the insolvency or financial condition of the debtor at any time before the closing of the case, (2) the commencement of the bankruptcy case, or (3) the appointment of or taking possession by a trustee in a bankruptcy case or a custodian before such commencement. Therefore, any provision which ties default, and thus consequent termination, to the filing for bankruptcy protection is unenforceable under the Code. Accordingly, any provisions of the licence agreement confirming termination rights by the licensor are best and most effectively triggered by non-performance and not by the filing for bankruptcy.

6) Tie termination to financial condition, not bankruptcy

Section 365(n) of the Code only provides protection for a licensee when a licensor petitions for relief under the Code. There is no corresponding provision to protect a licensor in the event that the licensee files for bankruptcy. The licensee's bankruptcy could result in a loss of income to licensor in the nature of reduced sales and royalties. In addition, a non-debtor licensor also runs the risk of a compromised value for its brand (if product quality suffers) and the possibility that its licensed rights are assigned to a third party during the course of the licensee's bankruptcy.

Accordingly, a licensor is well-advised to include independent obligations in the licence relating to the stature or condition of the licensee which do not trigger imminent bankruptcy but which could be indicative of a declining business. These provisions could include strong default consequences for non-payment or chronic late payment, which allows a non-paying or chronically delinquent licensee to be terminated *before* its poor financial condition causes it to declare bankruptcy. In addition to delinquent payment, another helpful tool is to establish a required minimum net worth of the licensee so that declining financial health can be identified long in advance of a filing for bankruptcy.

7) Obtain a security interest in the licensed property

To protect itself in the event of licensor's bankruptcy, a licensee may attempt to obtain a security interest in the licensed mark and goodwill or other licensed property. Most property owners, however, are reluctant to encumber their mark or assets in any licence agreement and have often pledged these assets to other creditors. On the other hand, a security interest may be a possibility, and it never hurts to ask. To effect an enforceable and valid security interest in a trade mark, it is crucial that the security interest be in both the trade mark and other assets to ensure the mark is accompanied by the associated goodwill.

Assuming perfection of a first priority security interest by proper filing and recordation, a security interest is a priority lien on the property and the trustee in bankruptcy, debtor-in-possession or court cannot sell that property clear of the lien. A drafter can protect against even the contingency of such a sale by providing in the security agreement that the lien attaches to the proceeds of any sale of the property.

A related alternative, for example, may be to convey the marks and goodwill or other licensed property to an escrow agent with licences back to the licensor and licensee, although this approach may give rise to other problems and could introduce yet another party (and its own business vagaries) to the equation.

8) Include a liquidated damages provision

Another way to maximize the scope of protection against a party to a licence agreement filing for bankruptcy is to provide in the licence a specific amount as liquidated damages in the event of breach by the bankrupt party or failure to perform any services

contemplated by the licence agreement. By including such language, if the contract is rejected, there is a definite amount for the court to find as the damages to which the non-debtor party is entitled. It may also discourage rejection of the agreement because it would become another claim against the bankruptcy estate. This type of provision therefore may provide some greater financial protection, assuming damages can be collected out of the proceeds of the estate.

9) The Bankruptcy Court does not recognize provisions which restrict assignment

The US Bankruptcy Code allows for a trustee or debtor-in-possession to assume a licence agreement and assign it to a third party even if the agreement contains provisions prohibiting assignment. The Code only requires that the assignee provide "adequate assurances of future performance" but provides no specific definition of "adequate assurances." Therefore, the non-debtor party to the licence agreement can find itself stuck in a contractual relationship with a party that it does not want to be in business with, such as a direct competitor.

To reduce the spectre of an unwanted licensing partner, the drafter might again attempt to provide a roadmap to the bankruptcy trustee by including contractual provisions which specifically define "adequate assurances" should there be an assignment in bankruptcy to a third party.

10) Provide for a right of first refusal

If the trustee or debtor-in-possession assumes a licence agreement where a licensee is the debtor, it may have the right to transfer, sell or assign the agreement to a third party (notwithstanding language prohibiting assignment). Thus, a non-debtor licensor should ensure that assignment language used in the licence agreement does not preclude or impair any rights which the non-debtor party may have as a creditor in any bankruptcy proceeding or the rights to object to any assumption or assignment of the licence agreement in such proceedings. A non-debtor licensor may also wish to provide instructive language, seeking the opportunity to intervene in the assignment process, either by required notice or a right of first opportunity and refusal.

While not an exhaustive list, the preceding 10 steps may prove to be essential. The potential damage caused to a party to a licence agreement when the other party to such an agreement petitions for relief under US bankruptcy law should remind drafting attorneys and business parties that knowledge of how the US Bankruptcy Code may affect a licence is invaluable. Safeguarding provisions may actually be all that stands in the way of unanticipated consequences for both the licensor and the licensee.

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