## It's Always Something: The Repeated Assaults on Licensee Rights in Bankruptcy

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No one has ever asserted that the bankruptcy arena is for the faint hearted. On the road to development of a plan of reorganization (or more commonly these days, a sale of all of the debtor's assets), there can be bruising fights between the debtor and its lenders, trade suppliers, unions, and landlords and between the tranches of senior and subordinated debt. Often these dust-ups are caused by the debtor's attempt to minimize its liabilities by forcing creditors to take less than they are owed, or paying them in TBDs— tiny bankruptcy dollars.

Reducing claims, however, is not the only game in town. Many times what is afoot is for the debtor to seek to enhance the value of what it owns regardless of who is hurt in the process. If what the debtor owns is intellectual property rights such as patents, copyrights, trademarks, and the like, it is the licensee who may be most at risk.

A short summary of bankruptcy law is necessary here.[1] Section 365(a) of the Bankruptcy Code says that a debtor[2] can assume or reject "executory contracts," which are largely understood to be contracts where each side still has meaningful performance due. A promissory note is not an executory contract because one side (the lender) did everything it needed to do when it made the loan. Only the borrower must still perform by paying the loan back. A supply contract for goods, on the other hand, is an executory contract because one side is required to continue to supply the goods and the other side is obligated to pay for them.

Debtors typically reject executory contracts because they are burdensome liabilities. A supply contract, for example, may be rejected because the debtor is the consumer of the goods and is locked into paying an above-market rate. But contracts can also be rejected because the debtor may see a better opportunity elsewhere. If the debtor was obligated to supply goods for below what the market now dictates, it might want to reject the contract so it can enter into a new contract with a third party willing to pay a higher price. Of course, this is unfair to the party left behind in the rejected contract, who was fully performing its side of the bargain.

Although now almost 30 years in the past, the epitome of this unfairness is the case of *Lubrizol Enterprises, Inc.*[3] in which the court allowed a debtor licensor to reject a patent license, leaving the licensee, who had fully paid for the licensed rights and needed them in the operation of its own business, irreparably harmed with only an unsecured claim that would be paid in TBDs as solace. The justification for this catastrophic destruction of the licensee's rights was so the debtor could relicense the patent rights to someone else and be paid twice for the same license.

Even Congress could not ignore the imbalance of rights highlighted in *Lubrizol* and reacted by amending the Bankruptcy Code in 1988 by enacting Section 365(n). Section 365(n) prevents an intellectual property licensee's loss of some of rights upon rejection of the license by the debtor although it does so by offering a Hobson's choice. The licensee may elect to allow the license to be terminated and assert whatever claims against the debtor it may have (subject, of course, to bankruptcy law and payment in TBDs), or it may elect to retain its rights. If it elects to retain its rights, it must continue to make all royalty payments and cannot offset any of damages it suffered against those amounts.

Although much better than the result in *Lubrizol*, Section 365(n) still means plenty of licensee pain following rejection. For example, the only rights the licensee can retain are those that existed when the bankruptcy case commenced. If the intellectual property is unfinished—software still being developed, a movie not yet in production, sequels not yet written—Section 365(n) offers no help and the licensee will lose rights to those assets. Even if the licensee has something of value during the bankruptcy case, any subsequent modifications or improvements, even such things as a patch for a bug in software, need not be provided to the licensee despite

what the license may provide. If the license doesn't allow the licensee access to what is needed to take full advantage of the intellectual property, such as the source code, trailers, or art work, Section 365(n) will be of no assistance. Finally, Section 365(n) is not self-executing. A licensee not paying full attention to its licensor's bankruptcy case will lose Section 365(n) rights if they are not timely exercised.

Section 365(n) has another critical problem. It only applies to intellectual property as that term is defined in the Bankruptcy Code, not in the broader sense used in business and in art.[4] Most glaringly, the Bankruptcy Code does not include trademarks as intellectual property, so licensees of those rights cannot even invoke Section 365(n). Lately, however, that appears to be a good thing. Several courts, have found ways to protect the rights of a trademark licensee against the debtor licensor's attempted rejection and retrieval of licensed rights. In *Exide Technologies*[5], for example, the Court of Appeals found a way to declare the license at issue not an executory contract, and thus not even subject to rejection. The concurring opinion went even farther and held that even if the license could be rejected, it did not mean that the debtor could regain the intellectual property free of the licensee's rights. Rather, the concurring opinion stated that rejection might be a breach by the debtor but otherwise of no impact on the licensee.

Last year, the concurring opinion was followed (and expanded) by another Court of Appeals in the *Sunbeam* case[6]. In *Sunbeam*, the court revisited *Lubrizol*, disagreed with it, and held that a trademark licensee continued to have the right to use the mark following rejection. Indeed, *Sunbeam* means that trademark licensees, forgotten by Congress when it enacted Section 365(n), may be substantially better off than licensees of other types of intellectual property and that other licensees may start to waive the protections of Section 365(n) for the broader rights announced in *Sunbeam*.

While *Exide* and *Sunbeam* may have suggested a safer world for the rights of intellectual property licensees, a new threat has materialized. Here again, a short exposition of bankruptcy law is required. Section 363(f) of the Bankruptcy Code allows a debtor to sell its assets "free and clear of any interest in such property" subject to certain conditions. The intent of Section 363(f) is that a buyer will pay more for assets if it does not have to worry about known and particularly unknown liens and other claims to the assets. The more value that is realized, it is widely thought, the better for all the creditors including those whose interests were stripped away in the sale. Those "interests" include intellectual property rights.[7]

Does 363(f) right to sell free of clear to intellectual property interests trump Section 365(n) provisions allowing a licensee to retain its rights in licensed intellectual property? Does it trump the rights protected in *Exide* and *Sunbeam*? Surprisingly, we don't know. In a very similar context, a court ruled that the debtor could sell property it owned that was leased and strip a tenant of its rights despite Bankruptcy Code Section 365(h) that expressly protects tenants of a rejected lease.[8] In large measure, however, the case was decided on the fact that the tenant failed to object, which was deemed akin to implied consent.

More recently, the buyer of the Blockbuster Video assets in the United States sought to prevent the Canadian subsidiary (whose assets it had not purchased) from using the Blockbuster name and other intellectual property. Despite the fact that the subsidiary had a written, fully paid-for license to use the intellectual property, the buyer asserted that the Canadian's affiliates rights under Section 365(n) and otherwise were extinguished when the assets were sold "free and clear" without objection by the subsidiary.[9] That the subsidiary had no practical ability to object to a sale its own parent was promoting was ignored.

If the buyer's position had been adopted by the court, it would have been catastrophic to the rights of the Canadian affiliate and its creditors. Not surprisingly, the matter settled leaving the issue unresolved. But, it is only a matter of time before another debtor or another buyer seeks this new avenue to destroy a licensee's bargained for and valuable rights. What can a licensee do in the face of this new attack?

First and foremost, regardless of how ironclad the contract, the licensee must closely monitor the licensor's

bankruptcy case. It is very easy to request notice of all activity in the case and have all the pleadings and other papers filed in the case sent directly to the licensee by email, fax or mail. Whoever is monitoring the case needs to look for motions to reject executory contracts and/or motions to approve sales of assets. Active participation in the bankruptcy case may be required. If the licensee finds its name in those motions, it needs to assess the best course if it wishes to retain its rights uninterrupted and in full. The licensee could take the position that the license is not executory and the debtor is not entitled to reject it. Or it could timely exercise its Section 365(n) rights by providing the notice required. Or it could object. There are several grounds for an objection to a sale free and clear of intellectual property subject to a license and it could prevent any court from finding an implied consent to the destruction of those licensed rights.

Perhaps if some court issues an opinion as dramatic as *Lubrizol* Congress will again step in and fix, ideally better than it did with Section 365(n), the latest attack on licensees. Until then, licensees, be alert and keep your shields up.

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1 The bankruptcy law discussed throughout this article is the federal United States Bankruptcy Code, found at title 11 of the United States Code.
2 The statute actually gives these powers to a trustee but by operation of other sections of the Bankruptcy Code these powers are available and often used by Chapter 11 debtors in possession of DIPs.
3 *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.)*, 756 F.2d 1043 (4th Cir. 1985)
4 Bankruptcy Code section 105 limits intellectual property to a trade secret, invention, process, design or plant protected under patent law, a patent application, plant variety, and a work of authorship or mask work protected under copyrights law.
5 *In re Exide Techns*., 608 F.3d 957 (3rd Cir. 2010)
6 *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*, 686 F.3d 372 (7th Cir. 2012).
7 *FutureSource LLC v. Reuters Ltd.*, 312 F.3d 281 (7th Cir. 2002).
8 *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC*, 327 F.3d 537, 545 (7th Cir. 2003).
9 See Reply of Blockbuster L.L.C. to the Objection of Receiver of Blockbuster Canada Co. to Debtors' Motion (I) to Reject Certain Executory Contracts and (II) Establish Expedited Rejection Procedures for Non-Lease Executory Contracts., *In re Blockbuster Inc., et al*, I0-14997-BRL (Bankr. S.D.N.Y. June 21, 2011).