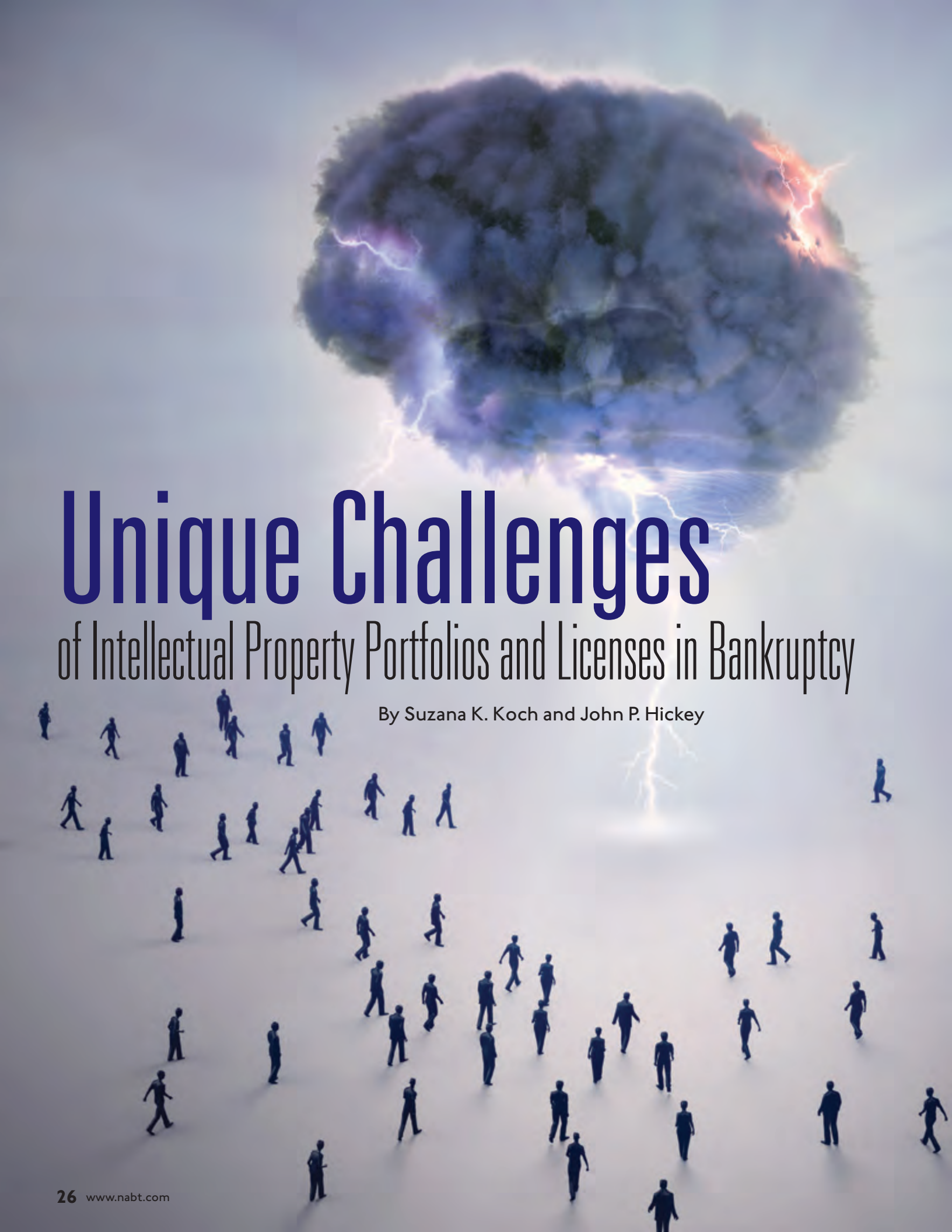

Unique Challenges

of Intellectual Property Portfolios and Licenses in Bankruptcy

By Suzana K. Koch and John P. Hickey

Many large bankruptcies in recent years were filed by companies with considerable intellectual property portfolios, including treasure troves of historic brands protected by trademarks: Polaroid, Sharper Image, Hostess and Kodak.

In 2009, a consortium of buyers paid $88 million for the Polaroid brand na me.[1] Even IP addresses can be sold; Borders' IP addresses alone sold in bankruptcy for $800,000 to $900,000. Borders had held one address for each cash register in its 1,200 stores.[2]

IP portfolios can add considerable value to a bankruptcy estate, but they are also subject to unique rules that generally do not apply to other forms of property and contract rights. Even the more general rules applicable to executory contracts in bankruptcy can have unexpected effects when applied to IP licenses. Moreover, many of those rules and effects are surprisingly unfavorable to debtors and trustees (including debtors-in-possession), notwithstanding the fact that there have been some highly lucrative and well-publicized sales of IP portfolios recently.

Debtor as Owner

From a legal standpoint, arguably the best position for a debtor in an IP-heavy industry, or a debtor with a strong brand, is that of sole owner and user of the patents, copyrights and trademarks in question. A debtor in this position does not need to worry about the various rules applicable to licensors and licensees of intellectual property. Of course, from a business standpoint, a company's business model may be highly reliant on either licensing out its own intellectual property, or on a lucrative license of a non-debtor's intellectual property. As further discussed below, a licensor may not be legally restricted from assigning its rights in the IP in question, but it cannot fully cancel such a license the way some businesses might want to do upon being advised that bankruptcy generally allows one to escape from burdensome deals. A licensee can face some graver challenges.

When the debtor is the sole owner, the trustee can use, sell or lease the intellectual property rights using § 363. For businesses with serious operational challenges, but iconic brands, such sales can unlock a tremendous amount of value.

The § 363 sale process for Hostess Brands resulted in proceeds of more than $850 million, more than 80% above previous valuation estimates.[3] The surprisingly positive results of the auction for Hostess' lenders was overwhelmingly based on the amount the purchasers of the various pieces of the Hostess empire were willing to pay for Hostess' iconic trademarks: One of the primary purchasers, Flowers Foods, paid $350 million for five bread brands, including Wonder, and ascribed $193 million of the purchase price to identifiable intangible assets - including trademarks. *Id.* By contrast, many of its physical assets, including eight entire bakeries and multiple other facilities, were so obsolete that even those purchasing the intellectual property did not want the physical assets used to make the very goods that the buyers had just bought the right to produce.

Debtor as Licensor and the Unique Ambiguity of Trademarks

The Bankruptcy Code contains special protections for licensees of intellectual property, though the status of trademarks in the statutory framework remains somewhat unclear.

When a bankruptcy trustee (including a debtor-in-possession) rejects an executory contract under which the debtor is a licensor of a right to "intellectual property," § 365(n) of the Bankruptcy Code gives the licensee the option to retain its rights for the duration of the rejected contract, even including any optional extension periods, as long as the non-debtor licensee continues to pay any royalties owed and waives and claims for setoff or administrative expenses that might arise from the license contract. However, while the definition of "intellectual property" in the Bankruptcy Code includes trade secrets, patents and copyrights, it does not include trademarks.[4]

Section 365(n) was added to the Bankruptcy Code in 1988, following a 1985 case in which the Fourth Circuit held that when an intellectual property license is rejected in bankruptcy, the licensee loses the ability to continue using any licensed copyrights, patents, and trademarks. *See Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985). However, some courts continued to treat *Lubrizol* as good law with respect to trademarks, suggesting that Congress' omission of trademarks from the Bankruptcy Code's new definition of intellectual property signaled deliberate intent for *Lubrizol* to continue to apply in such cases. *See, e.g., In re Old Carco LLC*, 406 B.R. 180, 211 (Bankr S.D.N.Y. 2009) ("Trademarks are not 'intellectual property' under the Bankruptcy Code . . . [, so] rejection of licenses by [a] licensor deprives [the] licensee of [the] right to use [a] trademark . . . ."); *In re HQ Global Holdings, Inc.*, 290 B.R. 507, 513 (Bankr. D. Del. 2003) ("[S]ince the Bankruptcy Code does not include trademarks in its protected class of intellectual property, Lubrizol controls and the Franchisees' right to use the trademark stops on rejection."); *In re Centura Software Corp.*,

KEY POINTS

1. IP portfolios can add considerable value to a bankruptcy estate, but they are also subject to unique rules that generally do not apply to other forms of property and contract rights.
2. The Bankruptcy Code contains special protections for licensees of intellectual property, though the status of trademarks in the statutory framework remains somewhat unclear.
3. Under 11 U.S.C. § 363(c)(1), a trustee cannot assume or assign any executory contract or unexpired lease if "applicable law" would excuse a non-debtor from accepting performance from an entity other than the debtor or debtor in possession and that non-debtor does not consent to such assumption or assignment.


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281 B.R. 660, 674-75 (Bankr. N.D. Cal. 2002) ("Because Section 365(n) plainly excludes trademarks, the court holds that [the licensee] is not entitled to retain any rights in [the licensed trademarks] under the rejected . . . [t]rademark [a]greement.").

However, in the most recent circuit decision addressing the issue, Judge Easterbrook of the Seventh Circuit stated bluntly that "an omission is just an omission." *Sunbeam Prods. v. Chi. Am. Mfg., LLC*, 686 F.3d 372 (7th Cir. 2012). However, *Sunbeam* still makes a very strong statement that non-debtor licensees cannot be deprived of their licenses by a debtor-licensor's rejection of a license, because it goes on to state that *Lubrizol* was simply decided incorrectly originally because it misunderstood the effects of a rejection of an executory contract—any executory contract, not just an intellectual property license. Specifically, under 11 U.S.C. § 365(g), rejection simply "constitutes a breach of such contract or lease" when a trustee rejects an executory contract or unexpired lease; rejection does not automatically rescind or terminate the contract. When a licensor breaches a license outside of bankruptcy, the licensee does not lose its rights to use the intellectual property in question, and nothing about the application of § 365(g) changes that.

Judge Easterbrook also cited to a second recent circuit opinion challenging the *Lubrizol* holding, this one a concurrence in *In re Exide Techs.*, 607 F.3d 957 (3d Cir. 2010) (Ambro, J., concurring). The main holding of *Exide* was that the trademark license in question was no longer executory and therefore could not be rejected, but Judge Ambro wrote separately to challenge the *Lubrizol* framework and the cases following it. Since it is a concurrence, it is not quite fair to say that the Third Circuit rejects *Lubrizol* and agrees with *Sunbeam*, but it appears likely to move in that direction with circuits split on this issue.

For financially distressed licensors of patents, copyrights and other forms of IP (possibly excluding trademarks, depending on the rule in the applicable circuit), the upshot is that one cannot terminate such licenses prematurely simply by allowing the licensee a monetary claim against the estate. This prevents a debtor-in-possession from, for example, canceling a number of nonexclusive licenses in order to offer a potentially more valuable exclusive license to a third party—or from simply forcing the renegotiation of the terms of existing licenses with its existing licensees.

Debtor as Licensee

When the debtor (or prospective debtor) is merely a licensee of intellectual property, however, it is potentially in a much more disadvantageous position. Indeed, if a prospective debtor's business model is heavily dependent upon a given license of intellectual property, negotiations with the licensor of that IP should figure prominently in pre-bankruptcy planning, particularly if the case would be filed in the Third, Fourth, Ninth or Eleventh Circuits. Not only may a debtor-licensee be prevented from assigning the license to a third party without the consent of the licensor, but the debtor might not even be able to assume the license for its own use.

The Bankruptcy Code generally allows a trustee to assign executory contracts notwithstanding any provision in the contract itself or in other applicable law that prohibits, restricts or conditions such an assignment, so long as the trustee assumes the contract (including satisfying the associated cure obligation) and provides adequate assurance of future performance. 11 U.S.C. § 363(f). This is a broad, sweeping power, however, it does have one significant exception. In the context of an IP-licensee debtor, the exception can swallow the rule: under 11 U.S.C. § 363(c)(1), a trustee cannot assume or assign any executory contract or unexpired lease if "applicable law" would excuse a non-debtor from accepting performance from, or rendering performance to, an entity other than the debtor or debtor in possession, and that non-debtor does not consent to such assumption or assignment.

With respect to IP licenses, "applicable law" frequently *does* excuse performance.

It can get even worse for debtor-licensees, particularly if they hold non-exclusive licenses. In *Perlman v. Catapult Entertainment (In re Catapult Entertainment)*, 165 F.3d 747 (9th Cir. 1998), the Ninth Circuit held that the debtor-in-possession could not even assume certain nonexclusive patent licenses, because (a) under federal patent law, nonexclusive patent licenses are personal and nondelegable, and (b) under § 363(c)(1), both assumption *and* assignment are barred if applicable law precludes *assignment* to a third party, even if the debtor has no actual intent of making such an assignment following assumption. This interpretation of § 363(c)(1) is called the "hypothetical test," and is also followed in the Third,[5] Fourth[6] and Eleventh[7] Circuits. The hypothetical test is not followed in all circuits, however; the First[8] and Fifth[9] Circuits have adopted a countervailing "actual test" that allows assumption if the debtor does not actually intend to make the non-debtor accept performance from a third party that the non-debtor would have the right to refuse, and multiple trial court decisions in the Second Circuit also strongly favor the actual test and criticize *Perlman*. *See, e.g.*, *In re Adelphia Commc'n Corp.*, 359 B.R. 65, 72 (Bankr. S.D.N.Y. 2007) (courts applying the hypothetical test "give insufficient attention to other provisions of § 365, link concepts that have no relation to each other, and yield results demonstrably at odds with the purposes of the statute").

Conclusion

Assessing the kinds of intellectual property first will help debtors and trustees understand their position – in addition to pointing them in the direction of which rules apply. As we've seen, intellectual property can be incredibly valuable, but it can also come with severe restraints.

FOOTNOTES:

1 http://money.cnn.com/2012/01/11/markets/brands_bankruptcy/.

2 http://blogs.wsj.com/cio/2012/11/16/the-hostess-liquidation-all-it-must-go/.

3 http://www.abfjournal.com/articles/whats-in-a-name-just-ask-hostess-brands-the-value-of-branding-in-bankruptcy/.

4 11 U.S.C. § 101(35A).

5 *In re West Electronics*, 852 F.2d 79 (3d Cir. 1988).

6 *RCI Tech Corp. v. Sunterra Corp. (In re Sunterra Corp.)*, 361 F.3d 257 (4th Cir. 2004).

7 *In re James Cable Partners*, 27 F.3d 534, 537 (11th Cir. 1994).

8 *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1997).

9 *Bonneville Power Admin. v. Mirant Corp. (In re Mirant Corp.)*, 440 F.3d 238 (5th Cir. 2006).