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Intellectual Property And Bankruptcy:

Strategies For Intellectual Property Licensees Who Depend Upon The Use Of Complementary Trademarks When A Licensor Files For Bankruptcy

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The bankruptcy of a licensor can dramatically impact the rights of an intellectual property licensee. As discussed below, that impact can be particularly acute when the value of an intellectual property license is dependent upon the continued use of a trademark because the Bankruptcy Code provides certain protections with respect to intellectual property licenses that do not extend to trademarks. As a result, a licensor's bankruptcy can place a licensee of intellectual property in an uncertain and exposed position. This article discusses strategies to preserve the rights of intellectual property licensees who depend upon complementary trademarks when a licensor files for bankruptcy, as well as drafting strategies to consider when preparing a license agreement.

Assumption And Rejection Of Contracts Under Section 365 Of The Bankruptcy Code

Section 365(a) of the Bankruptcy Code provides that a debtor may assume or reject any "executory contract" to which it is a party. An "executory contract" is typically defined as a contract under which the obligations of both parties are not yet fully performed, and the failure of either party to complete performance would be a material breach excusing performance by the counterparty. Put another way, an executory contract is a contract under which material obligations by both parties remain unperformed. If a debtor assumes a contract under section 365(a), the debtor will continue to be bound by the contract and is required by section 365(b)(1) to cure any contractual defaults. This means that the debtor must pay all outstanding amounts owed under the contract. On the other hand, if the debtor rejects the contract, it is relieved of its contractual obligations.

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Protections For Intellectual Property Licensees Under Section 365(n)

Section 365(n) of the Bankruptcy Code provides certain protections to intellectual property licensees in the event that their license agreements are rejected under section 365(a). Under section 365(n) if a licensor rejects an intellectual property license agreement and the rejection amounts to a breach entitling the licensee to treat the contract as terminated according to its own terms, non-bankruptcy law or an agreement with another entity, the licensee has the option to treat the agreement as terminated and file a claim for the resulting damages. Alternatively, the licensee may elect to retain its rights under the agreement to the intellectual property (in the form in which it existed as of the bankruptcy filing date) for the duration of the agreement and any period that it may be extended under non-bankruptcy law. If the licensee elects to retain its rights, the licensee will continue to be responsible for the payment of any royalties under the agreement.

Section 365(n) is a powerful tool for intellectual property licensees, but its applicability is limited by the definition of "intellectual property" under the Bankruptcy Code. As defined in section 101(35A) of the Bankruptcy Code, "intellectual property" means: "(A) trade secret; (B) invention, process, design, or plant protected under title 35 [of the United States Code]; (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 under applicable nonbankruptcy law." Trademarks are conspicuously absent from this list. The exclusion of trademarks from the definition of "intellectual property" can be problematic for licensees because the value of an intellectual property license is often tied to the use of a trademark. For example, a computer chip manufacturer with a license to produce chips using the process and design of a well-known technology company and to market the chips using the company's branding might have great difficulty selling them unbranded – without the use of the trademark – and might be able to sell them only at a dramatically reduced price. The rejection of the license agreement by the licensor could therefore deflate the value of retaining the intellectual property rights under section 365(n), as the licensee would retain only the right to use the licensor's process and design, not the right to use the licensor's trademark.

Strategies For Confronting The Rejection Of An Essential Trademark License

Licensees dependent upon the use of a trademark who wish to retain the value of their intellectual property licenses should not readily concede the loss of the right to use a complementary trademark when the underlying intellectual property license is rejected by the licensor. In some instances, the licensee may have potential arguments that can be used as leverage to negotiate a new license agreement with the debtor to ensure the use of both the intellectual property and the trademark in the future. A consensual agreement may have the effect of preserving both

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the value of the intellectual property license and the existing business relationship with the licensor. However, not every licensor will be willing to negotiate with the licensee or agree to acceptable terms.

In the latter event, the licensee might first advance the argument that the license agreement is not an executory contract and therefore cannot be rejected. *In re Exide Technologies*, 607 F.3d 957 (3d Cir. 2010), sets forth a blueprint for this argument. In *Exide* the licensee had a license to use a trademark in the industrial battery business. The licensor sought to reject the license agreement, but the United States Court of Appeals for the Third Circuit held that the agreement was not executory because the licensee had substantially performed, both by paying the full purchase price for the trademark and other property in a sale by the licensor over ten years earlier and by operating under the terms of the agreement since that time.

Despite the attractiveness of this argument, it may have limited application for many licensees because the circumstances of *Exide* were somewhat unique. The licensee in *Exide* purchased the trademark license in a transaction that involved the purchase of a substantial bundle of assets from the licensor that included physical manufacturing plants, equipment and inventory. The license agreement was one of 23 agreements entered into by the parties to effectuate the transaction. Due to the transaction's structure, the consideration for the license was delivered upfront, and the licensee's few remaining material obligations were satisfied by the time the licensor sought to reject the agreement. In a more prototypical transaction, the licensee might have continuing material obligations, such as the obligation to pay royalties to the licensor, that render the agreement executory for the purposes of assumption or rejection under section 365(a) of the Bankruptcy Code.

A licensee might also argue that despite the omission of trademarks from the definition of intellectual property under the Bankruptcy Code, the protections of section 365(n) should nevertheless extend to the trademark at issue. Support for this argument is found in the language of section 365(n), which extends its protections to any agreement "supplementary" to the relevant intellectual property license agreement, and in certain remarks by the United States Bankruptcy Court for the Southern District of Florida in *In re Ron Matusalem & Matusa of Florida, Inc*., 158 B.R. 514 (Bankr. S.D. Fla. 1993). In *Matusalem*, the court suggested (i) that in cases where the value of an intellectual property license is tied to a related trademark, the legislative history of section 365(n) indicates that courts may look to equity to protect the trademark license in addition to the intellectual property license, and (ii) that the definition of "work of authorship" under title 17 of the United States Code might be broad enough to encompass at least some trademarks. Unfortunately for licensees, *Matusalem*, like *Exide*, was a unique case, and was ultimately decided on other grounds. It involved a decades-long family feud, the roots of which dated back to 1872. The court viewed the bankruptcy case as a vendetta filed for the principal purpose of harming the licensee, even at the debtor's own expense, not as a legitimate attempt at reorganization. As a result, the court ruled that the debtor could not reject the agreement in question because there was no business justification for doing so. Other courts have nearly uniformly held that, despite the inequitable result, licensees may not continue to use a licensor's trademarks after electing to retain their intellectual property rights.

Although the arguments that a license agreement is not an executory contract and that the protections of section 365(n) should extend to a complementary trademark license will be steep uphill battles in most cases, contractual exclusivity provisions granting the exclusive use of intellectual property to a licensee can provide considerable leverage in its attempt to preserve the value of its intellectual property license. Section 365(n) specifically protects the right to enforce exclusivity provisions when an intellectual property licensee elects to retain its rights under a rejected license agreement. This is significant because the licensor, who, upon rejection may be free to re-license the trademark, may be hamstrung without the use of the accompanying intellectual property that is protected under section 365(n). Just as the value of protected intellectual property might be dependent upon a trademark, the value of a trademark might also be dependent upon the protected intellectual property. For example, the branding associated with a well-known foreign language education software program might be of little value without the right to use the underlying content that is subject to a copyright license protected under section 365(n). A licensee's exclusivity right can therefore be valuable, even if the intellectual property license is of little utility without the use of a trademark, because the threat of enforcement can incentivize a reluctant licensor to work with the licensee to negotiate a new agreement granting the right to use both the protected intellectual property and the complementary trademark or otherwise settle the dispute on favorable terms.

License Agreement Drafting Considerations

Licensees should keep the following considerations in mind when drafting license agreements in order to ensure that they will be able to avail themselves of section 365(n)'s protections. First, the license agreement should specifically state that, if the agreement is determined to be an executory contract, it is an intellectual property agreement within the meaning of section 365(n). The license agreement should also contain a representation and warranty by the licensor that the trademark is integral to the use of the other intellectual property components that are subject to the license. Although a court might separately parse any elements of the agreement that do not fit the definition of intellectual property under the Bankruptcy Code, these provisions may give the licensee a basis to argue that the trademark should not be severed because it is inextricably bound with the protected intellectual property. In addition, because a licensee that elects to retain its rights under a license agreement is responsible for royalty payments, the agreement should define "royalties" as narrowly as possible and separately identify the nature and purpose of any other payments to minimize their characterization as "royalties" by a court for the purposes of section 365(n). It may be advisable to specifically allocate a portion of the royalties payable for the right to use a trademark so that if the rejection of the license results in a loss of use of the trademark, the licensee does not have to continue to pay that portion of the royalties if it elects to exercise its right to continue the use of the remaining intellectual property under section 365(n). The agreement should also provide that rejection by the licensor is an event of default entitling the licensee to terminate the agreement, preserving the licensee's option to terminate under section 365(n)(1)(A), and contain a reasonable liquidated damages clause to provide clarity regarding the size of the licensee's claim in that event.

Conclusion

Licensees of intellectual property who depend upon the use of a complementary trademark to derive value from the license are placed in a precarious position when a licensor files for bankruptcy. Due to the Bankruptcy Code's structure, the licensor may be able to deprive the licensee of the use of the trademark, even while the licensee retains its intellectual property rights. However, as discussed above, a licensee armed with a carefully drafted license agreement and an exclusivity provision may be able to minimize the impact of the licensor's bankruptcy and leverage the exclusivity clause into the continued use of the trademark or a favorable settlement.