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Dumbing Down Intellectual Property: Chapter 11 Impact on IP License Agreements

Business Information for Clients and Friends of Shumaker, Loop & Kendrick, LLP

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Innovation and creativity are essential for competitive advantage and success in a global economy. The attendant intellectual property assets are the product of substantial capital investment, and companies should carefully manage risks associated with such assets.

A company may be a **LICENSOR** or a **LICENSEE** of intellectual property assets, where it invests significant capital in research and development or in production and distribution capabilities of licensed intellectual property. A risk to such investment is the Chapter 11 filing of a counter-party to a license agreement relating to patents and trademarks, which can jeopardize the contract and cause substantial financial loss.

On January 12, 2018, the U.S. 1st Circuit Court of Appeals issued a significant ruling that a company-licensee of a trademark lost its rights under the license when the Chapter 11 debtor-licensor rejected the contract. For perspective on this ruling, this article addresses the Chapter 11 impact on companies as a both licensors and licensees of intellectual property.

COMPANY AS LICENSOR

As a LICENSOR, a company must ensure its assets are protected and that the insolvent counter-party can continue to perform, often paying royalties, or the company-licensor can retract and recover the intellectual property assets. The Bankruptcy Code provides the debtor the right to (1) assume, (2) assume and assign, or (3) reject "executory contracts" including license agreements. If the debtor seeks to assume, or assume and assign (a frequent occurrence in Section 363 sales) a license agreement, it must "cure" or pay pre-petition arrearages, including unpaid royalties.

> Practical tip: a well-drafted license agreement should be "cross-defaulted" with related sales or supply agreements such that "cure" is defined to include unpaid invoices for products.

In addition, to assume a license agreement, a debtor must provide the company "adequate assurances of future performance", which should include evidence of capitalization and liquidity to perform and pay obligations incurred including royalties and invoices for the sale of goods. A well-drafted assignment provision can add protections for the company.

However, the Bankruptcy Code restricts a debtor's right to assume and assign a contract if applicable non-bankruptcy law prohibits assignment. Courts have held that patent licenses and nonexclusive trademark licenses are not assignable. Also, Uniform Commercial Code Section 2-210(2), regarding contracts for the sale of goods, prohibits assignment where it would materially increase the burden or risk. A company-licensor concerned about a proposed assumption and assignment should consider asserting this restriction.

A rejection in bankruptcy of the license agreement by the debtor is deemed a pre-petition breach of contract, meaning the company would have a pre-petition general unsecured claim, which often has little or no value. However, the company would be relieved of its ongoing performance obligations.

In sum, as a licensor, a company should be able to obtain ongoing performance from a debtor-licensee under its license, or recover its intellectual property assets, possibly sustaining a write-off for unpaid royalties or invoices, but not losing the underlying intellectual property assets.

COMPANY AS LICENSEE

By contrast, if a company is a licensee, it may have invested substantial capital in plants, people and infrastructure to support manufacturing products utilizing the licensed patents or trademarks.

If the debtor-licensor assumes the license agreement (a successful reorganization) or assumes and assigns the license (a Section 363 sale), it must "cure" pre-petition arrearages, and provide adequate assurances of future performance. As such, the impact on the company may be minimal as the company will continue to utilize the rights granted in the license agreement.

If the debtor-licensor elects to reject the license contract, the resulting inability to utilize the intellectual property assets under the license could have an enormous adverse impact on the company, including the loss of its capital investment. To moderate this harsh outcome, in 1998, the U.S. Congress passed the Intellectual Property Licenses and Bankruptcy Act which amended the rules on rejection of licenses of intellectual property, which expressly includes "patents, copyrights and trade secrets." Critically, this amendment did NOT include trademarks.

If the debtor-licensor rejects license agreements for patents, copyrights or trade secrets, the company may elect a claim for damages (still likely worthless) or retain its contractual rights in the intellectual property.

Court decisions uniformly rule that the 1998 amendment does not cover trademark licenses. When debtors–licensors of trademarks have rejected license agreements, courts have been required to determine the ongoing rights of the company-licensee in the intellectual property, if any.

In July, 2012, the U.S. 7th Circuit Court of Appeals (covering Illinois, Indiana and Wisconsin) in the *Lakewood Engineering & Manufacturing* ("Sunbeam") Chapter 11 case, ruled that the company-licensee's rights in the trademarks were not "vaporized" by the debtor's rejection of the trademark license. In this case, the debtor-licensor granted a trademark license to Chicago American Manufacturing ("CAM") to make box fans for one year. In recognition of CAM's required investment to make the fans, and due to known concerns about the debtor-licensor's financial condition, the license agreement specifically provided that CAM could directly sell any box fans that the debtor did not purchase. The debtor in fact failed to purchase the fans, and filed Chapter 11, where it sold its assets to Sunbeam Consumer Products, which caused the rejection of the CAM license to eliminate competition. When CAM continued to sell the unpurchased inventory as permitted by the license agreement, Sunbeam sued CAM for trademark infringement. The 7th Circuit ruling protected the rights of CAM to sell the fans on a limited basis.

As indicated at the outset, the 1st Circuit Court of Appeals (covering Maine, Massachusetts, New Hampshire, Puerto Rico and Rhode Island) in *Mission Product Holdings, Inc. v. Tempnology, LLC*, rejected the Sunbeam ruling, and held that trademark license rights are not protected when the debtor-licensor rejects the trademark license. In *Tempnology*, the debtor entered into a Co-Marketing and Distribution Agreement which granted the company (1) a non-exclusive license to copyrights, patents and trade secrets, (2) an exclusive right to distribute certain products manufactured by the debtor, and (3) an associated trademark license. The debtor rejected the agreement, and the company-licensee lost its rights, and presumably its investment, arising from the agreement.

<u>TAKEAWAYS</u>

1. The outcome for a company as a licensor when its customer files Chapter 11 is fairly clear, and thus, the risk is manageable.
2. Likewise, the outcome for a company as licensee when the license is assumed, or assumed and assigned, is predictable.
3. The risk arises for the company as a licensee in trademark license agreements that are rejected.
    - The majority of significant Chapter 11 cases are filed in the 3rd Circuit (Delaware) and the 2nd Circuit (New York), both of which have not ruled on this issue. They could go either way.
    - Note that the favorable Sunbeam ruling involved a very limited continuation of the license to allow CAM to simply sell unused inventory without the burden of a trademark infringement suit, on top of losing the license.
    - In *Tempnology*, the ongoing license rights were far more extensive, thus, the disparate rulings are at least rational.
    - There is a license drafting opportunity here for a licensee to protect at least its unsold inventory or other short-term rights to mitigate its losses.
    - Ultimately, the Supreme Court may resolve this split among the Circuits, though SCOTUS may wait until Delaware weighs in. Or, Congress could lift its quill to remedy the trademark omission to protect the rights of rejected licensees.

We hope you found this useful and informative. Please contact us if you have any questions about this or any other matter.

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