IP & BANKRUPTCY ALERT

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Intellectual Property Licenses and Bankruptcy

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The COVID-19 pandemic has already caused numerous companies to file for bankruptcy relief and will likely cause many more to do so. In this environment, it is particularly important for both licensees and licensors of intellectual property—patents, trademarks, copyrights, and trade secrets—to be aware of how the bankruptcy of one party to the license agreement may impact the other.

Generally, the Bankruptcy Code Permits the Debtor to Assume or Reject the Contract

The United States Bankruptcy Code usually affords the bankrupt entity (the "debtor") the right to assume or reject any particular license agreement. By assuming a license, the debtor formally acknowledges that it will receive benefits from the license and will continue to perform its terms. Under Section 365(b) of the Bankruptcy Code, in order to assume a license agreement, the debtor must promptly cure any of its prior breaches of the license and must provide "adequate assurance" to the Bankruptcy Court that it will be able to comply with the license's requirements for the remainder of the agreement's term. Following assumption by the debtor, both parties remain bound to the license, and are obligated to follow the license's terms.

Alternatively, a debtor can reject the license. Under the Bankruptcy Code, rejection of a license is treated as a material breach (not necessarily termination) of the license agreement. Following rejection of the license, neither party is required to continue to perform in accordance with the terms of the license, except as described below. The non-debtor party may choose to treat rejection as a termination, and will then be excused from continuing to perform and may file a claim for damages in the debtor's bankruptcy case.

Licensee is the Debtor: Can it Assign the License?

Most frequently, debtor-licensees want to assign their licenses to raise cash and avoid royalty and other obligations, but if permitted to do so, the licensor would lose control over who uses its intellectual property. Section 365(c) of the Bankruptcy Code protects the licensor against this fate by generally barring the assumption or assignment of a contract where applicable law permits the non-debtor party to refuse performance from third parties. For example, under patent law, only the patent owner can assign a patent, so a debtor-licensee cannot assign a patent license. However, this reliance on "applicable law" creates inconsistencies based on the type of license and federal jurisdiction of the Bankruptcy Court in which the debtor's bankruptcy is filed. In the Third, Fourth, Ninth and Eleventh Circuits, a debtor-licensee may neither assume nor assign a license if non-bankruptcy law forbids assignment. The First, Fifth, Sixth and Eighth Circuits allow debtor-licensees to assume the license, but prevent them from assigning the license. So it's important to consider the details when planning your strategy.

Licensor is the Debtor: Can it Reject the License?

In contrast, debtor-licensors more frequently seek to reject their licenses in favor of seeking more lucrative licenses or higher valuation for selling their licensed IP. If the debtor-licensor were to reject the license, historically, the licensee was unable to use the intellectual property, which was often crucial for the licensee's business. However, licensees now have a remedy under Section 365(n) of the Bankruptcy Code, at least for patent, copyright, trade secret or mask work licenses. If the debtor-licensor rejects the license, then the licensee may either consider the agreement terminated or retain its rights in the license that existed before the debtor-licensor filed the bankruptcy petition. The licensee must continue to pay royalties if it chooses to retain its rights, and the debtor-licensor must ensure the intellectual property remains exclusive or confidential. However, the debtor-licensor is no longer required to perform future affirmative obligations with respect to the intellectual property, such as providing software updates or technical support. Although Section 365(n) does not protect trademark licensees, in 2019, the Supreme Court granted them relief in Mission Holdings v. Tempnology. 139 S. Ct. 1652 (2019). In Tempnology, the Supreme Court held that a debtor's rejection of a trademark license agreement constituted a breach of the license and should have the same effect as a breach by a licensor outside of bankruptcy, which would not rescind the rights granted to the licensee, including the right to continued use of the licensed trademark. Thus, the Tempnology decision affords trademark licensees rights akin, if not identical, to those of licensees of other intellectual property by Section 365(n) of the Bankruptcy Code.

The Non-Debtor Can Still Recover Damages—If It Plans Ahead

As stated above, licensees and licensors that have been rejected by the debtor may assert a claim for damages in the debtor's bankruptcy case. Rejection damages claims are typically treated as general unsecured claims. In bankruptcy, the "absolute priority rule" generally requires that debtors pay secured creditors in full (to the extent of their collateral) before paying unsecured creditors. Certain unsecured creditors, including post-petition trade vendors and professionals, employees, and taxing authorities (i.e. administrative creditors), also have priority over general unsecured creditors. Depending on the amount of secured and priority unsecured claims asserted against the debtor, holders of general unsecured claims likely will not be able to recover the full value of their claims from the debtor. As one example, if all the licensor-debtor's assets are used to pay its secured creditors, then an unsecured licensee-creditor will not recover any money damages from the licensor-debtor.

Generally, a creditor can seek to reduce this risk by obtaining a security interest under Article 9 of the U.C.C. in the licensed intellectual property and using that perfected security interest to force the debtor to pay that particular creditor ahead of the administrative and general unsecured creditors. Normally, creditors can perfect security interests in intellectual property by filing a financing statement with the Secretary of State in the state where the debtor was organized. Doing so puts subsequent purchasers and creditors on constructive notice that the recording creditor has a prior interest in the intellectual property identified in the financing statement. If multiple creditors perfect separate security interests, then the creditor with the earliest perfected security interest has priority.

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