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Sublicensing from a Distressed Company

Are You Placing Your Future in the Debtor's Hands?

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Prior to 1988, nondebtor licensees were at the mercy of their debtor licensors: A debtor could use §365 of the Bankruptcy Code to reject an intellectual property license, thereby stripping the nondebtor licensee of intellectual property rights that might be critical to the ongoing viability of its business. In fact, in 1985, the Fourth Circuit approved just such a rejection in *Lubrizol Enterprises Inc. v. Richmond Metal Finishers Inc. (In re Richmond Metal Finishers Inc.),* 756 F.2d 1043 (4th Cir. 1985), *cert. denied,* 475 U.S. 1057, 106 S.Ct. 1285 (1986). The *Lubrizol* decision was widely criticized, and in 1988, Congress amended §365 of the Code to overturn *Lubrizol* and provide special protections for nondebtor licensees of intellectual property through the addition of §365(n) of the Code. Sublicensees of in-tellectual property might think that §365(n) will protect them from the risks posed by a sub-licensor's bankrupt-cy. Although this be-lief is consistent with the underlying goals of §365(n), it is prob-ably mistaken. This article summarizes the dilemma facing a company sub-licensing intellectual property rights from a distressed company and provides a few practical suggestions to help mitigate the sublicensee's exposure.


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Overview of §365(n) and the Dangers to a Sublicensee

To understand why §365(n) may fail to protect a sublicensee's rights, a brief overview of §365(n) is necessary. Section 365(n) provides that when a debtor licensor rejects an intellectual property license, the nondebtor licensee may elect either to (a) treat the license as terminated or (b) retain its rights to the intellectual property under the license, other than the right to specific performance of any license provision (other than an exclusivity provision). If the licensee elects to retain its rights under the license, it must make all royalty payments due under the license and is deemed to waive any setoff right or administrative claims arising under the license against the debtor. Intellectual property is separately defined by §101(35A) of the Code as (a) trade secrets; (b) inventions, process, design or plants protected under title 35; (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. Notably, trademarks, which often are thought of as "intellectual property" in other contexts, are outside of the scope of "intellectual property" for purposes of §365(n). Licensees of trademarks thus are fully exposed to the risk that a debtor licensor will reject the trademark license, thereby terminating the licensee's rights to the trademarks.[1] The same generally holds true for sublicensees of trademarks.[2]


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A sublicensee of intellectual property is faced with two potential dangers in a sublicensor's bankruptcy. First, the debtor sublicensor may seek to reject the sublicense—either in connection with a rejection of the underlying or "prime" license (for example, if the prime license is economically disadvantageous to, or no longer needed by, the debtor) or in an effort to maximize the value of the debtor's intellectual property rights (for example, by entering into a sublicense with economic terms more favorable to the sublicensor). Second, §365(c) of the Code may prevent the debtor sublicensor from assuming the prime license.

Feature

Section 365(c) provides that a trustee or debtor-in-possession (DIP) may not assume or assign an executory contract or unexpired lease if "applicable law ex-

1 *See In re HQ Global Holdings Inc.,* 290 B.R. 507, 513 (Bankr. D. Del. 2003); *but see In re Matusalem,* 158 B.R. 514, 522 (Bankr. S.D. Fla. 1993) (interpreting work of authorship broadly so as to include the exclusive right to use name for rum brand in a given territory, thereby protecting the right under §365(n)).

2 *See Major League Baseball Promotion Corp. v. Colour-Tex Inc.,* 729 F. Supp. 1035, 1041-42 (D. N.J. 1990) (finding that a licensee who has failed to satisfy a condition of the license or has materially breached the licensing contract has no rights to give a sublicensee and thus the sublicensee can be held liable for infringement of the licensor's copyrights or trademarks).

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cuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the DIP whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties...." Although courts have struggled with the meaning of §365(c), it is clear that this section has the effect of restricting the assumption or assumption and assignment of a broad range of contracts. Among the types of contracts that courts have found to be within the scope of §365(c) are patent and copyright licenses.[3] The bar on assumption contained in §365(c) is particularly troublesome in jurisdictions embracing the "hypothetical test" under that section, which basically prevents the debtor from assuming the prime license (without the licensor's consent), even if the debtor is not proposing to assign the prime license to a third party.

Outside of bankruptcy, a sublicensee's rights in licensed intellectual property generally are governed by the terms of the license and sublicense agreements and applicable state contract law. Unless some special protection is bargained for with the licensor, the sublicense is just a grant of some or all of the rights granted to the licensee under the prime license.[4] Based on this general proposition, it would seem that §365(n) should protect a sublicensee's rights if the debtor sublicensor assumes the prime license and then attempts to reject the related sublicense in an effort to maximize the value of the debtor's intellectual property rights. By the same token, this proposition suggests that not even §365(n) can save a sublicensee's rights if the debtor sublicensor rejects, or is not permitted to assume, the prime license.

The §365(h) Analogue

Unfortunately, it is impossible to give definitive guidance on a sublicensee's rights in either scenario because no court has yet analyzed a sublicensee's rights under §365(n). Several courts, however, have dealt with the similar issue of interpreting a nondebtor sublessee's rights under §365(h) of the Code. Like §365(n), §365(h) generally permits a nondebtor lessee under an unexpired real property lease with the debtor lessor to elect to retain its rights under the lease upon any rejection by the debtor.

In a scenario parallel to what could happen under §365(n) to a nondebtor sublicensee, courts have considered what happens under §365(h) when a debtor sublets real property to a nondebtor and then attempts to reject the lease under which it originally came into possession of the property.[5] Courts also have dealt with the question of whether §365(h) protects the sublessee when the underlying lease is deemed rejected under §365(d)(4) of the Code.[6] Courts in both contexts have held that §365(h) does not create a right for the sublessee to stay in possession of the property after the rejection or termination of the lease under which the debtor acquired its interest in the real property.[7] Instead, the question of whether the sublessee has any right to continue to stay in the leased premises after the rejection or termination of the underlying lease is a question of applicable nonbankruptcy law.[8] Because, in the real property context, this is a dispute turning on state law between two nondebtors (*i.e.,* the sublessee and the original lessor), bankruptcy courts frequently abstain from determining what rights, if any, the sublessee has against the lessor after the rejection of the lease.[9]

It appears logical that a court may use a similar analysis in construing the effects of §365(n) in a sublicense case. As with the real property sublease, the rights under a sublicense of intellectual property are derivative of the rights originally obtained by the debtor under the prime license. Therefore, in determining the rights of the sublicensee after the rejection or termination of the prime license, a court may look at the sublicensee's rights under applicable nonbankruptcy law upon the debtor licensee/sublicensor's breach, or the termination, of the prime license. Furthermore, given the fact that the dispute concerning the relative rights of the licensor and the sublicensee is a dispute between nondebtors based entirely on nonbankruptcy law, a bankruptcy court may find it appropriate to abstain from resolving the dispute.[10]

Although a detailed examination of the rights of sublicensees against licensors under nonbankruptcy law is outside of the scope of this article, it is worth noting that under applicable nonbankruptcy law, sublicensees usually will have no right to continue using the licensed intellectual property after termination of the prime license unless some sort of agreement exists between the licensor and the sublicensee to the contrary.[11] As described above (and similar to the analysis for real property subleases), a sublicense of intellectual property rights basically is a grant of some or all of the licensee's rights under the prime license.[12] Absent special contractual protections between the primary licensor and the sublicensee, if the licensee's rights under the prime license are terminated, there are likely no remaining rights for the sublicensee to exercise under the sublicense. Consequently, upon the rejection or termination of the prime license in the sublicensor's bankruptcy, a sublicensee will be left with nothing more than the ability to file a general unsecured damages claim against the debtor's estate.

Practical Considerations for Sublicensees

Parties considering entering into sublicense agreements for intellectual property should consider the risks posed by the potential lack of §365(n) protection when negotiating the agreements. These risks will differ depending on the business relationship of the parties and the type of intellectual property involved. For example, if a distressed manufacturer licenses a patent from a third party and then in turn sublicenses the patent to one of its suppliers for utilization in the manufacturing process, §365(n) issues

3 *See* Harner et al., "Debtors Beware: The Expanding Universe of Non-Assumable/Non-Assignable Contracts in Bankruptcy," 13 Am. Bankr. Inst. L. Rev. 187, 210-18 (2005).

4 *See, e.g., AMC Technology L.L.C. v. SAP AG et al.,* 2005 U.S. Dist. LEXIS 27095 at *31 (E.D. Pa. Nov. 3, 2005) (finding copyright licensee could not issue sublicenses that provided greater rights than the licensee/sublicensor enjoyed under license agreement).

5 *See, e.g., In re BCE West L.P.,* 257 B.R. 304, 306 (Bankr. D. Ariz. 2000); *In re Child World Inc.,* 142 B.R. 87, 88 (Bankr. S.D.N.Y. 1992).

6 *See, e.g., Chatlos Sys. Inc. v. Kaplan,* 147 B.R. 96, 98-99 (D. Del. 1992); *Keaty & Keaty v. Loyola Assoc. (In re Stalter & Co. Ltd.),* 99 B.R. 327, 330 (E.D. La. 1989); *Tebo v. Elephant Bar Rest. Inc. (In re Elephant Bar Rest. Inc.),* 195 B.R. 353, 356 (Bankr. W.D. Pa. 1996); *In re Dial-A-Tire Inc.,* 78 B.R. 13, 15-16 (Bankr. W.D.N.Y. 1987); *Envireco Int'l Motors Inc. v. Elmhurst Trans. Corp. (In re Elmhurst Trans. Corp.),* 60 B.R. 9, 10 (Bankr. E.D.N.Y. 1986).

7 *See Chatlos,* 147 B.R. at 100; *Keaty,* 99 B.R. at 331; *Tebo,* 195 B.R. at 357; *Child World,* 142 B.R. at 89; *Dial-A-Tire,* 78 B.R. at 16; *Envireco,* 60 B.R. at 10.

8 *See Eastover Bank for Savings v. Sowashee Venture (In re Austin Dev. Co.),* 19 F.3d 1077, 1084 (5th Cir. 1994). Under nonbankruptcy law, the sublease is often considered to be a partial assignment of the rights of the sublessor's rights under the main lease. *See Dial-A-Tire,* 78 B.R. at 16 (noting that under New York law the existence of a sublease depends on the existence of the main lease).

9 *See, e.g., Eastover,* 19 F.3d at 1084; *Tebo,* 195 B.R. at 357-58; *Dial-A-Tire,* 78 B.R. at 16.

10 *See* 28 U.S.C. §1334(c)(2) (providing for mandatory abstention in related to actions that could have been commenced in state court).

11 *See Rhone-Poulenc Agro S.A. v. DeKalb Genetics Corp.,* 284 F.3d 1323, 1334 (Fed. Cir. 2002) (finding that no bona fide purchaser rule existed to protect sublicensee when prime license was cancelled for fraud).

12 *See Aspex Eyewear Inc. v. E'Lite Optik Inc.,* 2002 U.S. Dist. LEXIS 14834 at *18 (N.D. Tex. Apr. 4, 2002) (noting licensee had conveyed all rights to sublicensee who was thus entitled to enforce patent); *Creative Labs Inc. v. Cyrix Corp.,* 1997 U.S. Dist. LEXIS 15704 at *5 (N.D. Cal. June 17, 1997) (noting that if the licensee's interpretation was correct, the sublicensor had conveyed rights greater than it possessed); *Miller Insituform Inc. v. Insituform of North America Inc.,* 605 F. Supp. 1125, 1131 (M.D. Tenn. 1985) (finding patent licensee can convey exclusive rights to a sublicensee if permitted to do so under license). Sublicensees dealing with the issues discussed in this article should consult with qualified intellectual property counsel regarding the consequences of the termination of the prime license and the sublicensee's corresponding rights, if any, under applicable nonbankruptcy law.

may arise. If the supplier's product only has value to the manufacturer sublicensor, the sublicensee may not want any protections in the event the sublicense is terminated other than being provided some mechanism to mitigate the damages caused by the termination or for the sublicensor to pay the sublicensee some fee in consideration for work in progress or finished inventory at the time the license is terminated.[13] If the sublicensee is using the intellectual property in its own business operations or to satisfy its obligations to third parties, however, the sublicensee may want some protection against the risks posed by the rejection or termination of the prime license. Similar issues under §365(n) also can arise in a different context, such as where the licensee/sublicensor is a distributor of software and the sublicensee is the end user.

The best protection for the sublicensee in the manufacturing scenario is to negotiate some form of protection with the sublicensor and the licensor (either by consent or separate agreement) at the outset of the relationship.[14] For example, the sublicensee may negotiate and obtain (a) a provision in the sublicense that allows the sublicensee to continue to exercise its rights to the intellectual property under the sublicense, even if the prime license is terminated or the licensee breaches the prime license, provided that the sublicensee pays any related royalties to the licensor and otherwise complies with the restrictions in the sublicense; or (b) an option providing that, upon the termination of the prime license, the sublicensee may assume the position of the sublicensor under the prime license.[15] The licensor may be attracted to this sort of agreement, as it insures that the licensor will continue to derive the benefits of its licensing agreement with the licensee even if the licensee files for bankruptcy and seeks to reject its obligations under the license. The sublicensor may be willing to agree to this type of arrangement, as it potentially reduces any damages claims against it arising from the termination or breach of the license agreement and the sublicense agreement.

Where the sublicensor is a software distributor, the sublicensee is likely to have far fewer options to protect itself. Because of the nature of the distribution relationship, the sublicensee may be unable to negotiate special protections with the licensor. The sublicensee in this situation, or the supplier to the manufacturer who is unable to negotiate with the original licensor, will be forced to consider other steps to try to protect itself. For example, the sublicense agreement could provide for the issuance of letters of credit or for the escrowing of some of the royalties so as to provide for compensation to the sublicensee in the event that the sublicense is terminated for any reason, which should include termination by virtue of the sublicensor's bankruptcy and the operation of §365.[16] If the distribution arrangement is based on standardized forms, however, it may be impossible for the sublicensee to bargain for these protections. Then the sublicensee's only option would be to have a contingency plan in place in case of the termination of the right to use the intellectual property.

If a sublicensee is faced with a distressed sublicensor and no special protections under its existing sublicense agreement, the sublicensee should take a proactive approach to try to mitigate the risks posed by the sublicensor's potential bankruptcy by trying to negotiate protections similar to those described above.[17] A sublicensee also should analyze, as described above, the impact of the loss of the right to use the intellectual property on its business.

Sublicensees of intellectual property need to be aware that §365(n) of the Code may not protect their rights to use intellectual property in the same way that it protects the rights of licensees. Sublicensees also need to understand and assess the potential risks to their sublicensed intellectual property rights associated with any rejection or termination of the prime license agreement in the sublicensor's bankruptcy. Sublicensees should consider these risks when negotiating and entering into sublicense agreements (or evaluating their existing sublicense agreements) and take proactive steps to mitigate the risks, to the extent possible. With careful planning, sublicensees may be able to reduce their bankruptcy risks and retain their rights in the licensed intellectual property; however, there is no guarantee, and sublicensees would be prudent to plan for the worst case scenario when dealing with a distressed sublicensor. ■

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13 Typically, absent a transition agreement, a sublicensee cannot sell or otherwise use products that incorporate licensed intellectual property after the termination of the sublicense. A sublicensee thus should consider a pre-negotiated fee or put option with respect to such products in its possession upon termination of the sublicense. If possible, a sublicensee also may want to obtain an irrevocable letter of credit or other security for this fee or put option; otherwise, damages for breach of this obligation most likely will be considered an unsecured rejection damages claim in the sublicensor's bankruptcy. Alternatively, the sublicensee could try to negotiate this fee or put option directly with the original licensor (if the end product ultimately is for the licensor's benefit), thereby avoiding the sublicensor's bankruptcy altogether.

14 In many cases, entry into the sublicense already requires some form of negotiations with, or consent from, the licensor because of assignment restrictions either contained in the prime license or provided for under applicable nonbankruptcy law. For instance, in the case of nonexclusive patent licenses, a licensee cannot sublicense the patent unless the license agreement specifically authorizes the granting of sublicenses. Some commentators suggest that "[a]n authorized sublicense is in effect an agreement with the licensor," independent of the prime license. Brunsvold, Brian G. and O'Reilly, Dennis P., *Drafting Patent License Agreements* 37 (BNA 4th ed. 1998). A court that accepts this analysis, which is akin to an attornment under real property law, may determine that a sublicensee's rights under the sublicense are not affected by any rejection or termination of the prime license in the debtor's bankruptcy case.

15 The provision suggested by subclause (a) basically is intended to provide the sublicensee with the protections set forth in §365(n) for licensees. Both of the suggested provisions create, to differing degrees, a direct relationship between the licensor and the sublicensee and thus would require the agreement of the licensor (which the sublicensee should insist be obtained at the time the sublicense is executed). Moreover, these provisions assume that the debtor's estate would have no interest in the prime license after the termination or rejection of the prime license. A sublicensee must be mindful of the automatic stay imposed by §362 of the Code in the sublicensor's bankruptcy, which, among other things, prohibits any act to obtain possession or control over property of the debtor's estate, in drafting and enforcing the terms of the sublicense and any related agreements.

16 *See supra* note 13.

17 Whether the sublicensee in this situation tries to negotiate a direct license, option, nondisturbance or other agreement with the licensor, the sublicensee should try to take these steps prior to any bankruptcy filing by the sublicensor. Otherwise, the sublicensee may encounter issues under the automatic stay of §362. Also, any changes to, or transfer of, rights under the sublicense immediately prior to the sublicensor's bankruptcy may be subject to scrutiny and challenge in the bankruptcy case. Accordingly, obtaining protections at the outset of the relationship obviously is preferable.