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## Patent Licensees: Beware Impact of Licensor Bankruptcy

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Patent, copyright and trade secret licensees, and the licensing professionals representing them, have taken comfort in the protection afforded by §365(n) of the Bankruptcy Code since its enactment. In the event of the licensor's bankruptcy, the license would survive.

But a closer examination reveals key areas where this comfort is unwarranted. Consequently, a licensee should approach a licensor in a weak or potentially weak financial position with great caution before investing in, and building a business around or business line based on, the in-licensed technology.

This article will examine, in the patent license context, the major areas where §365(n) does not represent a complete solution and will suggest some possible approaches to improving the licensee's position.

### **Section 365(n) of the Bankruptcy Code**

Generally, a debtor in bankruptcy is entitled to reject executory contracts, which would include the substantial majority of patent licenses.

However, it was thought that this result was too harsh on "intellectual property"<sup>1</sup> licensees, including patent licenses, so in 1988 the Bankruptcy Code was amended to provide, in §365(n), that if an intellectual property license is rejected by the bankrupt licensor, the licensee could opt to retain a license to the IP, subject to continuing to pay royalties and certain other conditions (a "365(n) election"). See 11 U.S.C. §365(n). It is the potential severity of those other conditions that should cause concern on the part of licensees.

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A licensor bankruptcy would undoubtedly create uncertainty over the exact status of a license. In bankruptcy, the licensor may either: (1) preserve the obligations of both parties and continue as if nothing changed, or (2) reject the license, seeking relief from its obligations under the contract. 11 U.S.C. §365. The licensor is not required to decide until confirmation of its plan of reorganization, which may represent a long period of uncertainty. 11 U.S.C. §365(d)(2).

While the licensee may make a motion to compel the licensor to decide whether to assume or reject the license, the licensor or its creditors may oppose the motion and the bankruptcy court may grant extensions of time. This potentially extended delay may impede the licensee's ability to enter into other agreements with a third party and also make definitive plans and decisions difficult.

If the second option (rejection) is chosen by the licensor, the licensee may make a 365(n) election and retain a license to the IP. However, as discussed below, the 365(n) election is not a panacea: the licensee still faces some risks that it should be aware of and, armed with this knowledge, take actions to mitigate.

### **Rights to Improvements May Be Lost**

It is important to note that under a 365(n) election, a licensee is entitled to retain only such licensed IP rights as existed on the filing date of the bankruptcy petition. 11 U.S.C. §365(n)(1)(B).

In many if not most instances, a patent license will include rights to future developments and improvements, often in the form of continuations or divisionals of licensed patents. However, in the case of a 365(n) election, these negotiated rights are cut off at the moment of the filing of the licensor's bankruptcy petition. And this cut-off may have the effect of impeding the licensee's use of the pre-bankruptcy IP.

For example, if the licensor invents an improvement that does not infringe a licensed patent, the licensor may now be able to patent and license improvements to third parties that would compete with the pre-bankruptcy licensee, and prevent such licensee from making, using or selling its own improvements. Of course, the licensee could license these improvements again from the original licensor, but they may already have been paid for as part of the original bargain. In effect, the licensee may have to pay twice in order to prevent the sale of such improvements to a competitor.

In cases where a new technology establishes the standard for relevant products or methods, the licensee may no longer be able to market the original non-improved product because of the potential risk of liability for selling products that are now below the standard of care.

Consequently, as a result of the petition filing cut-off, not only are the licensee's rights limited as compared with what was initially bargained for, but the value of the rights retained may be substantially diminished.

## Problems Enforcing Licensed Patents

Another significant problem may arise when the licensee attempts to enforce its in-licensed patent rights against a third party infringer.

As a general rule, a licensee cannot enforce the patent unless the patent owner is a party to the infringement litigation. The exception is when a license is equivalent to ownership, such as when an exclusive licensee holds all of the substantial rights in a patent. Note that the Bankruptcy Code preserves a licensee's right to protect an exclusivity provision in the subject license agreement, as discussed below.

A typical provision in an exclusive license for less than all substantial rights in a patent (for example, an exclusive license in a specific field or a license that is exclusive against the entire world except the licensor) would allow the licensee to bring infringement suits against third parties in certain situations—usually when the licensor has failed to do so—and require the licensor to join as a party plaintiff. A non-exclusive licensee, or so called “bare” licensee, has no standing to be a party to litigation. See *Morrow v. Microsoft Corp.*, 499 F.3d 1332, 1341 (Fed. Cir. 2007).

Section 365(n) was enacted in 1988, before the appeals court for the Federal Circuit, in *Vaupel Textilmaschinen v. Meccanica Euro Italia*, clarified its position on a licensee's right to pursue patent infringement suits. 944 F. 2d 870 (Fed. Cir. 1991). The court stated that the owner must be joined as a party to prevent the possibility of two suits on the same patent, unless the exclusive licensee is the licensee of all substantial rights in the patent.

Yet, in the 2006 amendments to the Bankruptcy Code, §365(n) was not amended to preserve an exclusive licensee's ability to enforce its rights against third party infringers in the event that the debtor/licensor is unwilling or unable to participate in a suit. The question then arises whether, under §365(n), the debtor/licensor must comply with such a provision in a license agreement.

The Bankruptcy Code is ambiguous. Section 365(n)(1)(b) provides that:

(n)(1) If the trustee rejects an executory contract [...], *the licensee under such contract may elect—*

(B) *to retain its rights (including a right to enforce any exclusivity provision of such contract, but excluding any other right under applicable nonbankruptcy law to specific performance of such contract) under such contract [...], to such intellectual property [...], as such rights existed immediately before the case commenced.*

11 U.S.C. §365(n)(1)(b) (emphasis added).

While written broadly, the Code does not specify if these exclusivity rights are enforceable against a third party infringer or only against a licensor who is attempting to renege on the licensee's exclusive rights.

The Senate report does not clarify whether the drafters of §365(n) intended to require the licensor to support the licensee's efforts to enforce a patent (with or without an express license provision). On one hand, just like the Code, the Senate report contains a phrase that may suggest such intent: "For the term of the rejected license and any period for which such license could have extended, the licensee under the rejected license [...] is *entitled to any judicial relief necessary to enforce that set of rights.*" S. Rep. No. 505 at \*9 (1988) (emphasis added).

On the other hand, the report states that "exclusivity would be preserved to the licensee" and "to this extent, the licensee is given *the right to compel specific performance, i.e., to enjoin the licensing to another* of the rights granted by the contract to the licensee." *Id.* (emphasis added).

This latter statement suggests that the drafters intended only to provide licensees with a cause of action against the licensors. The report does not explicitly address a licensee's right to compel a licensor to be a plaintiff in patent infringement litigation, *i.e.*, to "enforce any exclusivity" against a third party.

On the flip side, defending the licensee instead of using the licensed IP offensively, the report is clear: "the licensee cannot compel licensor to defend the licensor's patent against [an] infringement claim." *Id.* at \*9. If the licensee cannot demand any assistance from the bankrupt licensor for defense, even where assistance was a part of the license agreement, does it follow that the licensee should be able to compel the licensor into offensive action to prosecute infringement?

The authors are unaware of any decision that directly addresses this situation. Thus, while §365(n) allows exclusive licensees to prevent licensors from granting competing licenses, it may not provide licensees with the tools necessary to protect exclusivity against third party infringers.

Even if a licensee were able to enforce the patent without the licensor, or if the licensor were required merely to fulfill the formal function of acting as a plaintiff, the process might well require licensor's assistance: access to data and the cooperation of the patent owner and inventors. Once again, a court might decide not to compel a bankrupt licensor to provide data or cooperation or to require its employees to provide assistance to the licensee. (Note that the licensee could still obtain required information by using third party subpoena power; this power is limited and cumbersome.)

The clear possibility of a licensee's inability to pursue patent infringers after a 365(n) election, or at best the lack of clarity on the issue, represent another significant limitation to §365(n) protection.

### **Prosecution of Patent Applications**

Another limitation of §365(n) relates to patent procurement through "prosecution" of patent applications.

After a licensor declares bankruptcy, the licensee of patent applications may have difficulty continuing the prosecution of the applications and consequently obtaining patent protection. There are two common types of patent prosecution provisions in license agreements:

(1) the licensor may remain in control of patent prosecution, but if it abandons issued patents through failure to pay maintenance fees, or decides to abandon the applications for whatever reason, the licensee has the option to step in and take such actions, or (2) the licensee may prosecute, often in consultation with the licensor.

In either case, access to data and cooperation of inventors may also be important to the licensee's ability to obtain patents based on in-licensed patent applications. The licensee may need to obtain the inventors' signatures on oaths or declarations. The licensee may need access to laboratory notebooks and data, especially if the licensee attempts to establish prior conception or reduction to practice of the invention. Access to data may also be important in the context of interference and reexamination proceedings or litigation.

The U.S. Patent and Trademark Office has established procedures that allow patent assignees to prosecute patent applications where an inventor is inaccessible or non-cooperative. See 37 C.F.R. §1.47. Presumably, the same procedures would be available to licensees that have assumed prosecution. In the event of licensor's bankruptcy, however, the licensee may not be able to secure needed access at all, and certainly if it represents an undue burden on the licensor's bankruptcy estate, *e.g.*, where the estate would need to sue an inventor to secure cooperation.

### **Possible Drafting Fixes**

Precautions taken in license drafting may counteract some limitations on the licensee's rights in a §365(n) situation, but the effectiveness of such a strategy is largely untested.

On the one hand, provisions that attempt to modify a licensee's rights if the licensor files for bankruptcy are generally not enforceable. 11 U.S.C. §§541(c)(1) and 365(e)(1). On the other hand, notwithstanding a debtor/licensor's rejection of a license agreement, Congress clearly intended at least some of the license provisions to be enforceable. See 11 U.S.C. §365(n)(3-4) ("the trustee shall — (A) to the extent provided in such contract, [...], provide to the licensee any intellectual property [...] held by the trustee; and (B) not interfere with the rights of the licensee [...] including any right to obtain such intellectual property [...] from another entity").

The Senate report on §365(n) specifically distinguishes unenforceable affirmative obligations from enforceable obligations such as "providing the licensee with access to the existing intellectual property, including the delivery or turnover of any existing items specifically required by the contract, and not interfering with the licensee's right thereto." S. Rep. No. 505 at \*8 (1988).

The report provides specific examples of enforceable provisions, such as provisions for transferring trade secret manufacturing technology, where the licensor had agreed to supply components but is now unable to satisfy its obligations in bankruptcy. *Id.* at 13. The report suggests that the key considerations for enforceability are (1) the existence of the IP prior to bankruptcy filing, (2) the explicit or implied agreement in the language of the license, and (3) that the obligation is predominantly a ministerial act of the estate. *Id.* at \*10-11.

With these considerations in mind, a licensee may draft a provision that requires the licensor to expeditiously decide whether to accept or reject a license within a specified time period, e.g., within a reasonable time after filing for bankruptcy. An alternative would be a provision requiring a licensor not to oppose licensee's motion to compel election. Although these provisions would modify the licensor's rights in bankruptcy, they would pertain to IP that existed before the bankruptcy, would be explicit in the agreements, and arguably would be largely ministerial in nature.

As a general rule, a bankrupt licensor cannot be forced to be a party to litigation after it has filed for bankruptcy. Yet, the nature of a patent enforcement action is such that the licensors are often participating in name only.

A licensee could draft a provision to facilitate a bankrupt licensor's participation in suits by contractually minimizing any financial burden to the licensor. The agreement could provide that the licensee would hold the licensor harmless from, and indemnify the licensor against, any costs, expenses, or liability that the licensor may incur in connection with such action.

Although it is unclear whether these provisions can be enforced in bankruptcy, their presence may increase the likelihood of the licensor's participation in suits.

If a licensee is concerned about being sued with respect to infringement of IP improvements no longer included in the licensed IP due to the operation of §365(n), the licensee could negotiate in the original license agreement a covenant not to sue in such a situation. However, it is unclear whether an extension of this provision that requires the licensor to contractually obligate its future licensees not to sue its pre-bankruptcy licensee on improvements IP would be enforceable; it is an affirmative obligation that potentially reduces the value of the improvements IP.

Manufacturing technology and material transfer provisions are enforceable according to statute and the Senate report and would be included in the original license agreement. Analogous provisions that require the licensor to transfer data and materials pertaining to the out-licensed pre-bankruptcy IP at no costs to the licensor, within a specified period of time after filing for bankruptcy, may also be enforceable.

### **Possible Structural Fixes**

Finally, more drastic alternative mechanisms for protecting the licensee's investment in cases where the licensor's solvency may be in doubt could include assignment and license back agreements regarding the patents of interest, or assignment of the relevant patents to bankruptcy-remote special purpose vehicles. A security interest in the patent in favor of the licensee to secure the debtor/licensor's obligations under the license agreement could also be put in place, although its ultimate success in improving the licensee's position in respect of the rejected license agreement is doubtful.

This article is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

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In respect of post-bankruptcy cooperation, requiring that licensor employment agreements make the licensee a third party beneficiary, may help the licensee secure the aid of the employees in patent prosecution.

These more complex mechanisms may be tougher to negotiate, but are clearly very helpful.

## **Conclusion**

Licensee and its counsel should always consider the impact of a licensor's potential bankruptcy when undertaking license negotiations. Section 365(n) is no doubt very helpful, and a vast improvement over the pre-existing situation. It is in fact unique in the world. However, it has some significant limitations, which must be considered both before and after a licensor's bankruptcy.

## **Endnotes**

1. Section 101(35A) of the Bankruptcy Code defines "intellectual property" to include only trade secrets, inventions, patent applications, plant varieties, works of authorship, or mask works. See 11 U.S.C. 101(35A) (2000). Trademarks are not included.