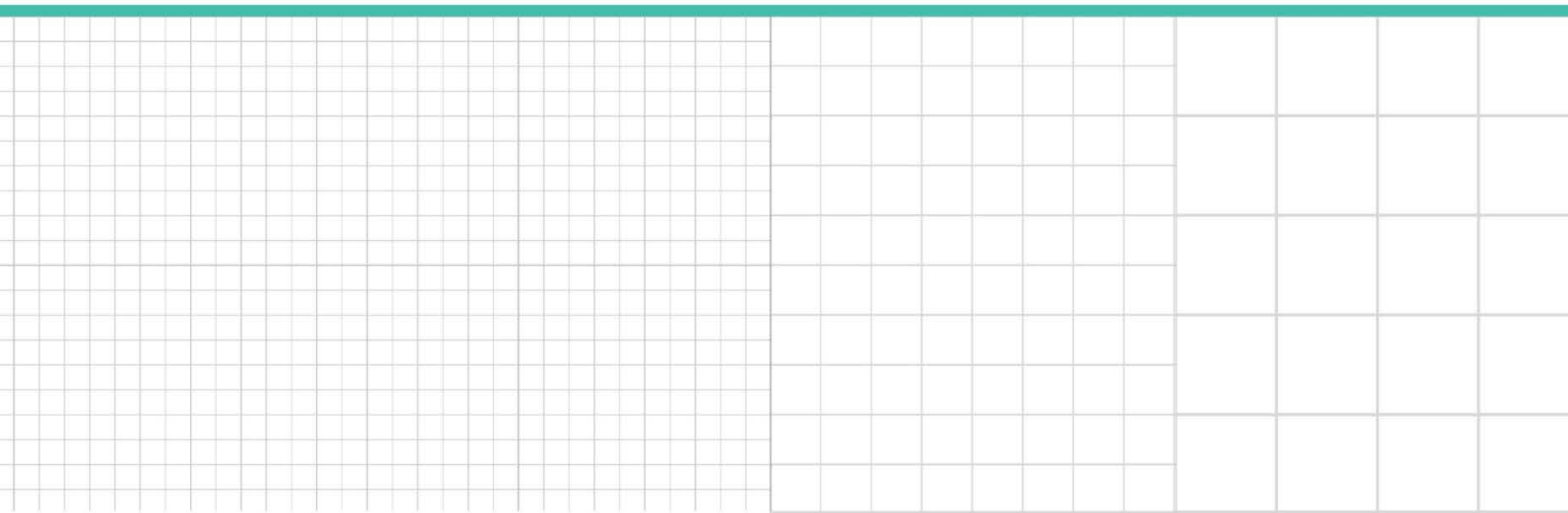
Professional Perspective

IP Ownership, Licensing Agreements, and Bankruptcy

Howard Wettan, Richard Graham, and Amy Bagdasarian, White & Case

Reproduced with permission. Published April 2020. Copyright © 2020 The Bureau of National Affairs, Inc.
800.372.1033. For further use, please visit: http://bna.com/copyright-permission-request/



IP Ownership, Licensing Agreements, and Bankruptcy

Contributed by Howard Wettan, Richard Graham, and Amy Bagdasarian, White & Case

***Editor's Note**: Any views expressed in this publication are strictly those of the authors and should not be attributed in any way to White & Case LLP.*

Bankruptcies in the already troubled retail sector will likely only accelerate as the economic downturn sparked by Covid-19 continues, and bankruptcies in other sectors, such as travel and hospitality, may also result. Companies in these sectors typically hold significant intangible assets such as trademark brands and data that constitute trade secrets. As a result, they should carefully evaluate how intellectual property ownership and licensing is structured within their larger corporate groups. At the same time, these companies' lenders, whose collateral packages may include IP or IP licenses, should also ensure they understand these ownership and licensing arrangements.

Concerns for Debtors and Creditors

There is considerable uncertainty under section 365(c) of the U.S. Bankruptcy Code as to whether a company in bankruptcy, that is a licensee of IP, can continue to benefit under certain IP license agreements. To use this uncertainty to its advantage, a larger corporate group may consider separating ownership of certain key IP assets from operating subsidiaries that incur debt and run higher insolvency risks.

This may enable the corporate parent to retain control of the rights to use the IP assets in a potential subsidiary bankruptcy. If a bankruptcy subsequently occurs, the parent, or the affiliate that holds the IP (an IP Holdco) could potentially limit the right of any bankrupt subsidiary to assume the intra-group license and continue to benefit from the IP rights, which could confer upon the corporate parent considerably more influence during the proceeding.

Conversely, creditors that lend to these companies should assess the risks connected with a borrower that licenses key IP rights from others, including from its own affiliates. Creditors should consider measures to mitigate those risks in the course of negotiating and executing credit transactions, particularly when a borrower's obligations are not guaranteed by, or secured by the assets of, the larger corporate family. Numerous recent cases illustrate the pitfalls for creditors that fail to fully comprehend these risks, including *In re Trump Entm't Resorts, Inc.*, 526 B.R. 116 (Bankr. D. Del. 2015), which involved the creditors of Trump Taj Mahal.

Section 365(c)

The Bankruptcy Code generally permits a bankruptcy trustee (or the debtor-in-possession), subject to court approval based on a business judgment standard or review, to either assume or reject each of the company's executory contracts, 11 U.S.C. §365(a). A contract is "executory" if material obligations remain for each party to perform. Licenses of IP are generally considered executory under bankruptcy law as a result of obligations remaining on both sides, such as payment, quality control and covenants not to sue. The code further permits the trustee to assign to a third party an assumed contract even if assignment is otherwise prohibited by the contract or under applicable law. 11 U.S.C. §365(f)(1).

Nevertheless, Section 365(c) carves out a significant exception to these powers: the bankruptcy trustee may not "assume or assign" a contract if applicable law would excuse the other party from accepting performance or rendering performance to someone other than the debtor, i.e., if it is a "personal services" contract (unless the non-debtor party provides clear consent to the assignment in the license agreement or separately).

Courts have generally held this exception applies to licenses of IP when the debtor is the licensee, as IP license are generally personal in nature and therefore typically cannot be assigned without consent under applicable non-bankruptcy law. One exception to this rule is exclusive copyright licenses, which are treated like owned assets and therefore considered assignable. See *In re Golden Books Family Media Entertainment, Inc.*, 261 B.R. 311 (Bankr. D. Del 2001).

The inability of a trustee or debtor in possession to assign a debtor's executory contract as a result of the carve-out in Section 365(c) can have more drastic consequences than simply preventing the license from being assigned to a third party. Certain U.S. circuit courts have held that even when bankruptcy trustees or debtors-in-possession intend only to assume these licenses without assigning them, they may not do so, effectively empowering an owner who licensed IP to a debtor in bankruptcy to terminate the license.

 ©2020 The Bureau of National Affairs, Inc.

There is a longstanding circuit split on this point. Some courts (including the Third, Fourth, Ninth, and Eleventh Circuits) read the statute to bar the assumption of IP licenses even if no assignment is contemplated, using the "hypothetical test." See *In re West Elecs. Inc.*, 852 F.2d 79 (3d Cir. 1988); *Perlman v. Catapult Entm't, Inc. (In re Catapult Entm't, Inc.)*, 165 F.3d 747 (9th Cir. 1999); *Resort Computer Corp. v. Sunterra Corp (In re Sunterra Corp.)*, 361 F.3d 257 (4th Cir. 2004).

Other courts (such as the First and Fifth Circuits) only bar assumptions of IP licenses if a further assignment is actually intended, using the "actual test." See *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1997); *Bonneville Power Admin. v. Mirant Corp. (In re Mirant Corp.)*, 440 F.3d 238 (5th Cir. 2006).

Given this uncertainty as to whether a license grant can be assumed by a licensee debtor in bankruptcy, both creditors and licensee debtors must plan for the possibility that a license of key IP rights may not survive a bankruptcy. From a creditor's standpoint, the issue is magnified by liberal bankruptcy venue rules that give debtors considerable leeway in determining where to file their bankruptcy case. See 28 U.S.C. § 1408. Directors and managers may consider controlling law on the issue of "actual" versus "hypothetical" tests in making these determinations.

Strategic Considerations for Corporate Groups

For corporate groups considering operating company bankruptcy risk, the ability to retain control, and potentially withhold, key IP assets during and after the bankruptcy of an operating subsidiary can protect the assets from being caught up in the operating company's bankruptcy, and in some circumstances may also offer powerful leverage. Creditors that might otherwise recoup the most value by the sale of a subsidiary as a going concern may be unable to do so without negotiating with a corporate parent who holds the IP.

It is common for certain entities within larger corporate organizations to obtain financing without providing guarantees or pledging assets from other members of the corporate group. In addition, it is very common for corporate groups to maintain key IP and other intangible assets in separate asset holding companies within the corporate group, typically for tax purposes. Beyond offering tax benefits, such structures can further benefit corporate parents that hold operating subsidiaries at risk of insolvency and of defaulting on loan obligations.

In hypothetical test jurisdictions, the corporate parent or IP Holdco may be able to object to the assumption in bankruptcy of intra-group licenses pursuant to which a debtor subsidiary is entitled to use certain IP, and as a result, the corporate parent may hold additional leverage before and during a bankruptcy proceeding. Creditors of the debtor subsidiary may hesitate to foreclose on a debtor subsidiary if a bankruptcy proceeding could follow that results in the subsidiary losing the rights it needs to operate, destroying value otherwise available to satisfy the creditors' claims. This possibility could incentivize creditors to instead extend loan payments that are due rather than foreclose.

Nevertheless, a corporate parent considering this approach should weigh the following potential hurdles.

Claims of Fraudulent Transfer

Frequently, the restructuring of IP assets within a corporate group does not occur at the start of organization or business operations, but well into the life of an enterprise. A corporate parent that decides to transfer IP assets previously held at an operating entity into a separate holding company should take steps to mitigate the risk that removing IP assets from a debtor subsidiary would be deemed a fraudulent transfer.

Although the law of voidable transactions varies somewhat from state to state, a fraudulent transfer generally occurs if a debtor transfers property with an intent to hinder, delay, or defraud its creditors. Even without such intent, fraudulent transfer may also occur if the debtor has transferred property for less than reasonably equivalent value and the debtor is either insolvent on the date the transfer is made, becomes insolvent as a result of the transfer, is engaged in business for which it holds inadequate capital, or intends to or believes it will incur debts that it cannot pay on time.

A reorganizing corporate parent would need to be able to demonstrate that it is transferring IP from a corporate subsidiary that is solvent, reasonably capitalized and not subject to any reasonable expectation of default. If a future bankruptcy of the corporate subsidiary that previously held the IP does occur, a corporate parent may face scrutiny on this point, particularly if the bankruptcy filing occurs shortly after the transfer of IP assets.

©2020 The Bureau of National Affairs, Inc.

If there is any risk of this, the corporate parent should conduct the transfer, subject to a careful process (potentially with assistance from an independent accounting firm) that establishes that the transfer will occur at arms' length in exchange for reasonably equivalent value. The corporate parent should also ensure that any royalties charged for a license of IP rights back to the corporate subsidiary do not exceed what otherwise might be determined fair consideration or reasonably equivalent value.

Existing 'J. Crew' Blockers

Often, a reorganized operating subsidiary not only already holds IP assets, but has also pledged its assets to secured lenders. In a well-known case, retailer J. Crew formed an affiliate that was not a party to the secured lending agreement, and then, using an amount of assets it was permitted to invest in the affiliates, transferred or "dropped down" valuable IP to the new affiliate. Since this case, many creditors have revised their documentation, adding "J. Crew blockers" to preclude these transfers.

J. Crew blocker provisions can take different forms, such as prohibiting the designation of unrestricted subsidiaries absent consent from the lender and restricting the transfer of core assets such as material IP to unrestricted subsidiaries. Consequently, a corporate parent undergoing this type of reorganization of IP assets that involves transferring IP assets out of an operating subsidiary should make sure it does not run afoul of existing secured lending agreements.

Assignability and Executory Nature of License

Any license of IP rights from the IP Holdco to a debtor subsidiary should clearly establish that the license is personal, non-assignable, and conditioned on the control of the debtor subsidiary by its current management. This will help the corporate parent make the case under section 365(c) that the license would not otherwise be assignable under applicable law and thus may not be assumed in a "hypothetical" test jurisdiction. The licensor should further structure the license to state clear ongoing obligations for both the licensor and licensee so that it would necessarily be characterized as executory and subject to section 365.

Consolidation of IP Assets

It is important to observe separate corporate formalities and take note of certain other rules relevant to corporate separateness. Under the bankruptcy doctrine of "substantive consolidation," a court may, if it determines appropriate circumstances exist, consolidate the assets and liabilities of different affiliated entities into a single debtor's bankruptcy estate, treating the related entities as one consolidated entity for bankruptcy purposes. If this occurs, the liabilities of each of the consolidated debtors are treated as liabilities of all of the consolidated debtors, and the assets of each consolidated debtor are generally treated as common assets of all of the consolidated debtors.

In these cases, the IP Holdco's ownership and license of IP to debtor subsidiaries may become partially or totally irrelevant, as the IP Holdco may become unable to separate the rights to use the IP among the debtor entities. Although it is said that courts should use the remedy of substantive consolidation sparingly, it becomes more likely to occur when corporate formalities are neglected and separateness in function and affairs are blurred. *Chemical Bank New York Trust Co. v. Kheel*, 369 F.2d 845, 847 (1966).

Maintaining corporate separateness by, for example, observing all formalities, maintaining clearly separate accounting and control, ensuring all intra-group transactions with the IP Holdco are made at arms' length, and having a robust board at an IP Holdco will help reduce the risk of IP asset consolidation. In order for a bankruptcy court to respect an IP Holdco's independence and decision not to join the bankruptcy, that company should also consider, if possible, having one or more independent directors whose votes are necessary for any bankruptcy filing, as well as other typical "ring-fencing" measures.

Breach of Fiduciary Duty Claims

Any employees of the corporate parent who may be involved in the IP Holdco's decision to object to an assumption of the intra-group license by a subsidiary debtor in its bankruptcy proceeding should not serve on the subsidiary's board of directors to avoid any claims that they are breaching their fiduciary duties.

©2020 The Bureau of National Affairs, Inc.

Considerations for Creditors

As corporate groups may position IP rights away from debtor subsidiaries, whether to have bargaining power against creditors or for other reasons, creditors should scrutinize, and consider resisting, these structures. Ideally, creditors should require that any subsidiary to which they are extending credit own all key IP asset so that the IP assets are part of the creditor's collateral package and remain part of the entity's bankruptcy estate.

Security Interests

If key IP rights already sit within the corporate group but are held outside the entities that are parties to the credit arrangements, a creditor should seek to obtain a guarantee from any entity holding the IP and a security interest therein, preferably one that is not subordinate to any other security interest. Creditors should ensure that in obtaining any such security interest, the security agreement reserves for creditors the right to take, use and license the IP rights as they see fit, at least as required to operate the remaining corporate assets.

Pursuant to "strict foreclosure" rules, without a post-default agreement from the grantor of the security interest, the secured creditor would need to sell any foreclosed assets through a "commercially reasonable" sale; however, the sale of the IP rights could be in conjunction with the sale of the operating assets of the debtor subsidiary.

Diligence on Intra-Group Licenses

If neither ownership of material IP nor security interests in the IP are possible, creditors must carefully evaluate any licenses of IP held by their borrower or the other loan parties and determine whether those licenses will survive if the entities file for bankruptcy. Using the hypothetical test, the estate of the debtor subsidiary may be unable to either assume the license or assign the license, unless the non-debtor licensor provides clear consent.

Court opinions have varied as to what type of assignment consent language in a license agreement is sufficient. The Fourth Circuit found that language in a license providing the licensor's consent to assignment by the licensee to a successor-in-interest was insufficient to also enable an assumption of the license because there was no separate express consent to assumption. *In re Sunterra Corp.*, 361 F.3d 257 (4th Cir. 2004).

Other courts have rarely gone this far and have found the inclusion in the license of an express consent to assignment to successors-in-interest adequate to also authorize assumption and assignment. *In re Quantegy, Inc.*, 326 B.R. 467 (Bankr. M.D. Ala. 2005). However, courts have also regularly found that provisions that permit assignments with consent, not to be unreasonably withheld, are inadequate. See *Wellington Vision, Inc. v. Pearle Vision, Inc. (In re Welling Vision, Inc)*, 364 B.R. 129 (S.D. Fla. 2007); *In re Aerobox Composite Structures*, 373 B.R. 135 at 142 (Bankr. D.N.M. 2007).

Separate Consent Agreements

When a creditor begins the process of entering into a loan with a borrower who licenses IP, an existing IP license agreement may not, for practical reasons, be able to be amended. The license agreement may not contain an adequate consent to assignment (and if the *Sunterra* standard is applied, licenses rarely will). In these cases, a creditor might instead insist that the licensor entity enter into a consent agreement, known as an "attornment" or "non-disturbance" agreement, ensuring that the creditors would not encounter obstacles to assuming the license in bankruptcy. These consents or other licenses or permissions must be carefully drafted to ensure they broadly apply to all types of circumstances in default and are irrevocable.

The consent should be clearly drafted, to be effective in the event of either bankruptcy or foreclosure proceedings, state or federal. *In re Trump Entm't Resorts, Inc.* illustrates one example of what can go wrong if the consent is not clearly drafted. There, Trump AC Casino Marks LLC sought to terminate a trademark license agreement for the benefit of the operators of the Trump Taj Mahal, which was subject to a consent agreement stating that Trump AC consented to the assumption of the trademark license agreement by certain first lien lenders "'upon and following' the enforcement of its rights under the Pre-Petition Credit Agreement."

The bankruptcy court held the consent inapplicable, because the consent applied only to an enforcement action under state law, and did not expressly contemplate a federal bankruptcy proceeding, and the bankruptcy court in that case thus permitted termination of the trademark license agreement.

©2020 The Bureau of National Affairs, Inc.

Creditors should also draft any separate consent agreements carefully to ensure they are irrevocable. That may involve structuring the consent to be non-executory (stating that the creditors relied on the consent and have no outstanding obligations to perform on behalf of the licensor), or even going further to structure the permission to include an express, irrevocable, sub-licensable, non-exclusive license grant to the creditor to use the IP rights upon default as required to operate the debtor's business. These actions would make it difficult for any circumstances, including the licensor's own possible bankruptcy, to upend the consent.

Avoid Unexpected Consequences

As companies with key IP assets and complex ownership and licensing structures approach potential bankruptcies and foreclosures, it is critical to consider these structures in light of certain nuances under U.S. bankruptcy case law. Rules that potentially bar assumption of license rights, even intra-company license rights, could have unexpected consequences in bankruptcy, conferring leverage on licensors within corporate groups to the detriment of unwary creditors. Creditors should be well-versed in the relevant bankruptcy rules to best position themselves in the event of any potential bankruptcy by the party to which they are extending credit.

©2020 The Bureau of National Affairs, Inc.