BY-LINED ARTICLE

Acquiring Intellectual Property from a Bankrupt Licensor

By Samuel W. Apicelli and Edward Graeme Crothall

May 11, 2010
The Legal Intelligencer

This article explores the opportunities and pitfalls attendant in a purchase of intellectual property through a Section 363 bankruptcy asset sale. As a 363(f) sale is completed "free and clear" of all pre-bankruptcy interests, the negotiations of a buyer of IP assets focus more on the schedule of contracts to be assigned to the buyer and of those to be rejected by the debtor, rather than the language of the representations and warranties.

The fate of an improvident buyer in a 3rd U.S. Circuit Court of Appeals case, *In re Cellnet Systems Inc.*, illustrates some of the hazards to be navigated in an IP asset purchase agreement with a debtor-licensor.

The value and strategic importance of IP assets has skyrocketed over the last 15 years. According to a Swiss Reinsurance Company report, the ratio of the value of hard assets relative to intangible assets among the major industrial companies of the world went from 62 percent/38 percent in 1982 to 38 percent/62 percent a decade later. The asset value of many of today's technology companies' patents, trademarks and copyrights far outweigh the value their physical assets.

The current contraction of the economy has forced companies, including many once highflying technology darlings with rich IP portfolios, into Chapter 11 bankruptcy. The scarcity of credit has prevented many bankrupt companies from obtaining the financing necessary to pursue a viable reorganization. As a result, valuable assets are jettisoned at a fraction of their value in 363 asset sales or simply abandoned. Companies that have access to capital or strong cash reserves should seize upon the current downturn to strengthen their IP portfolios. *The Wall Street Journal* recently characterized the buying, trading and breaking up of large companies in Chapter 11 reorganizations as the hottest venue for M&A activity.

Warner's pending $33 million bid to acquire most of bankrupt Midway-Games' assets appeared to be driven almost exclusively by their interest in Midway's IP catalogue. Likewise, the immense global appeal of the Polaroid brand and Polaroid's broad patent holdings were touted as the foremost reason for a recent joint venture's $87.6 million purchase of most of Polaroid Corp.'s assets out of a bankruptcy. Bankrupt Nortel — whose long-term evolution third-generation mobile patent assets alone are expected to generate up to $2.9 billion in royalties over the next 15 years — is currently auctioning substantial portions of its assets at fire sale prices.

In another case, a technology firm in which venture capitalists had invested over $700 million had anticipated selling itself for roughly $1 billion prior to bankruptcy. The firm was auctioned off at a mere $8 million in a 363 bankruptcy sale.

As a general matter, Chapter 11 bankruptcy acquisitions may be executed either through a Section 363 asset sale or a confirmed plan of reorganization or liquidation. Section 363 sales, which courts have been authorizing increasingly to sell off all or substantially all of the debtor's assets, are preferable in speed and cost to a sale through a formal plan. Although creditors may object to the sale before the court on certain limited statutory grounds, they are not entitled to vote as they would for a proposed plan.

Besides the bargain prices, 363 sales offer significant advantages to firms seeking investment opportunities. Assets purchased in bankruptcy are generally sold free and clear of any liens, claims, encumbrances or interests of third parties. The buyer may cherry-pick assets and liabilities, even some with anti-assignment provisions, generally without the risk of incurring any successor liability. Finally, the bankruptcy court's stamp of approval should ensure the "good faith" of the purchaser, the finality of the sale and the enforceability of purchase documents, such as non-competes, service agreements or licenses.

Navigating the transfer of IP rights through the lens of the Bankruptcy Code demands considerable caution and due diligence, especially when license agreements are involved. The sale of an IP license agreement out of bankruptcy involves a two-step process: the debtor's assumption of the license; and the debtor's assignment of the license to the purchaser. A debtor, however, can only assume or assume and assign an intellectual property license if that license qualifies as an executory contract and the debtor is not in violation of any non-monetary contractual obligations. The debtor must also cure any monetary obligations and provide adequate assurances that it can perform its contractual obligations.

A debtor-licensee's capacity to assign a license without the licensor's consent will vary depending upon the court's definition of an executory contract, the scope of the licensed rights, the assignability of the contract under applicable nonbankruptcy law and the court's adoption of one of the three divergent interpretations of Section 365(c)(1) of the Bankruptcy Code. The inability to assume and assign critical IP licensee rights may be sufficient to undermine the value of the remaining assets and scuttle the entire deal.

In re Cellnet Data Systems Inc. highlights some of the issues that may arise in a purchase of a debtor-licensor's rights. Three years prior to filing bankruptcy, Cellnet, a developer of a wireless data network, entered into an agreement that provided a joint venture, BCN, with an exclusive license to use all of Cellnet's intellectual property rights outside the United States. The license covered patents, copyrights, trade secrets, hardware, software and source codes, and provided for the grant of sub-licenses by the joint venture to manufacturers of components.

After extensive pre- and post-filing negotiations, the purchaser, Schlumberger, committed to a $225 million asset purchase agreement (APA) whereby Schlumberger would purchase all of Cellnet's IP assets, with the specific exception of the BCN foreign IP license agreements. Pursuant to the terms of the APA, Cellnet notified the licensee that it was rejecting the exclusive license. The licensee then elected to retain its rights under the license as per Section 365(n) and continue to use the intellectual property and pay royalties. Both the debtor and Schlumberger claimed that they were entitled to receive the $2.2 million in royalties.

In affirming the ruling of the bankruptcy and district courts in favor of the debtor, the 3rd Circuit reasoned that because the buyer had expressly excluded the license agreement from the assets it had purchased, it had in effect severed the right to receive royalties from the IP it had purchased.

Section 365(n) of the Bankruptcy Code provides special protections for the "licensees of intellectual property" following a debtors' rejection of the IP license. Specifically, the licensee may elect "to retain its rights (including a right to enforce any exclusivity provision of such contract, but excluding any other right under applicable non-bankruptcy law to specific performance of such contract) under such contract and under any agreement supplementary to such contract, to such intellectual property ... as such rights existed immediately before the case commenced ... ."

If the licensee chooses to retain its rights under the licensing agreement, after the debtor rejects the contract, the debtor in possession is effectively absolved of all affirmative obligations it may have under the IP license. Negative covenants, such as respecting an exclusivity provision or a confidentiality agreement, remain in force. The licensee cannot, however, enforce any affirmative debtor obligations under the license to provide technology maintenance, updates or other assistance. The licensee must also waive any claims, such as breach of contract or setoff actions, against the debtor and continue all royalty payments "due under such contract for the duration of such contract."

Schlumberger had operated on the mistaken assumption that, as owner of the underlying assets and the bearer of the obligation to respect the negative covenants, it should be the royalty beneficiary. As Schlumberger had explicitly excluded the license agreements from the APA, the court found the license agreements remained property of the debtor's estate after the APA and until the debtor formally rejected the contract. Once the licensee has exercised his post-rejection 365(n) rights, the court continued, the plain language of the statute requiring the payment of royalties "due under such contract" dictates that the renewed royalties are directly linked to the rejected contract, not the intellectual property.

As the court's decision was based upon the express contractual language of the APA, a future buyer of IP licenses could easily protect himself by expressly assigning the royalty payments to the buyer in the event that the licensee elects to retain its rights. A buyer may also attempt, as Schlumberger had unsuccessfully done so in this case, to strip the IP of the license agreement through the 363 asset sale itself. If an unwary licensee does not object to the 363 sale of the IP "free and clear of all interests" through a court request for adequate protection, it is assumed to consent to the sale free and clear of any licensee interests.

The simplicity of the contractual remedy to Schlumberger's problem masks the larger complexity that Section 365(n) creates for IP purchases. Schlumberger retained the U.S. IP rights without any right to control their exploitation abroad and without any compensation for the loss of such control. Without negotiating a binding commitment directly with each licensee, a buyer cannot determine with any certainty whether it will have control over the intellectual property it is purchasing. Unless a buyer is prepared to assume the debtor's license with the licensee, and the debtor is in fact capable of assuming and assigning such license, 365(n) can serve as a barrier to 363 asset purchases. A vigilant buyer could negotiate the creation of an escrow indemnity fund to compensate for the adverse impact a 365(n) election may have on the remaining assets in the proposed transaction.

Depending, however, upon the nature of the licensing agreement, the absence of any affirmative obligation under 365(n) to maintain the agreement, provide technological updates, or communicate new trade secrets under future improvement clauses, may offer a buyer significant leverage in negotiating the abandonment of the license by the licensee. Where the license involves trademarks, trade names, service marks, trade dress and domain names that are not within the scope of Section 365(n), the ability to sever the licensee's trademark rights from the related software, and thereby destroy those rights, may deter the licensee from exercising its 365(n) election rights with respect to the other intellectual property as well. A savvy licensee may however anticipate and neutralize such an eventuality by broadening the number of goods with which the trademarks are used, procuring a security interest in the trademark itself or imposing onerous liquidated damages clauses in the event of termination.

As an asset purchase agreement may involve representations, warranties and a contract schedule that hinge upon litigable license assumptions and assignments, buyers must incorporate these contingencies in their valuation and protect their interests with indemnification clauses, out-clauses and a careful analysis of the circuit's prior case law and the language of each licensing agreement.

As illustrated by Schlumberger's demise in *Cellnet*, the protections 365(n) offers the non-debtor licensee can trap the unwary. While the purchase of IP assets out of bankruptcy in the current economic downturn may represent a great bargain, the buyer must be mindful of the complex and evolving nature of the law at the intersection of intellectual property and bankruptcy.

Samuel W. Apicelli is a partner in the intellectual property practice group of Duane Morris in Philadelphia. A former mechanical and electrical product development engineer, he has represented clients before U.S. federal courts, the USPTO, and before administrative agencies such as the European Community Trademark Office.

Edward Graeme Crothall is a graduating 3L at Temple University School of Law, and worked as a summer associate at the firm in 2009.

This article originally appeared in The Legal Intelligencer and is republished here with permission from law.com.