

# Licensing Disputes and Insolvency in the United States and United Kingdom

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**T**he convergence of global markets and the growth of intellectual property over the last 30 years have created unique challenges for inventors and companies seeking to develop, monetize, and enforce their IP rights, which are becoming an increasingly more significant part of their businesses. Recent statistics published by the World Intellectual Property Organization (WIPO) suggest that patent applications increased from approximately 926,000 in 1985 to more than 1.8 million in 2007.<sup>1</sup>

While an increase in patent filings is somewhat abstract when viewed in a vacuum, a working paper published by the Federal Reserve Bank of Philadelphia provides two estimates that are useful in assessing the magnitude of this growth and the relative importance of intangibles to companies: U.S. private gross investment in intangibles was at least \$1 trillion in 2000, and intangibles represented a third or more of the market valuation of all U.S. stocks at the end of the first quarter of 2001.<sup>2</sup> Given the relative importance of intangibles to the market value of companies, it's not surprising that licensing disputes involving IP often result in high-stakes, "bet-the-company" litigation, which increasingly involves jurisdictions outside of the U.S. For example, the U.K. case of *Nokia v. InterDigital Corp.* [2004] EWHC 2920 (Pat) and [2005] EWCA Civ 614 involved a dispute regarding the royalties associated with the licensing of certain mobile phone patents, resulting in a payment of nearly \$300 million to InterDigital.

## Bankruptcy Law and License Agreements

### *U.S. Bankruptcy Code*

Article 1, section 8, clause 4 of the U.S. Constitution provides Congress with the power to enact "uniform Laws on the subject of Bankruptcies throughout the United States." U.S. bankruptcy law is codified in title 11 of the U.S. Code.<sup>3</sup> Congress enacted the U.S. Bankruptcy Code in 1978 to

replace the Bankruptcy Act of 1898.<sup>4</sup> The overarching goals of the U.S. Bankruptcy Code are providing a uniform mechanism for maximizing and preserving the assets of a debtor and an efficient means of liquidating claims against the debtor's bankruptcy estate equitably among creditors.

Section 101(35A) of the U.S. Bankruptcy Code defines "intellectual property" as including patents, copyrights, and trade secrets. The treatment of IP license agreements is often governed by Section 365 of the U.S. Bankruptcy Code, which addresses assumption, assignment, and rejection of executory contracts and unexpired leases.<sup>5</sup> In addition, Section 363 of the U.S. Bankruptcy Code, which addresses the use, sale, or lease of property, may come into play in respect to the sale of the underlying IP that is the subject of the license agreement.

### *U.K. Insolvency Law*

U.K. insolvency law is derived primarily from the amended Insolvency Act of 1986. The overarching goal of U.K. insolvency law is to free the debtor from overwhelming debts so that a fresh start can be made (subject to some restrictions) and to ensure that the debtor's assets are shared out fairly among the creditors. Under U.K. law, there are three key persons in insolvency matters: an administrator who is appointed to run the insolvent business, a liquidator who is appointed to manage the winding up and sale of the debtor's assets, and a licensed insolvency practitioner who can act as an administrator, liquidator, or advisor to parties in the insolvency proceedings. Unlike in the United States, there are no specific statutory protections related to IP license agreements under U.K. insolvency law.

## Bankruptcy by a Licensor/Licensee

### *U.S. Perspective*

The purpose of the U.S. Bankruptcy Code—to maximize the size of a debtor's estate and distribute property of the estate equitably among creditors—results in

provisions that sometimes function to the detriment of particular creditors in the name of fairness to all. For example, Section 363(f) permits a trustee or debtor in possession to sell property free and clear of an interest in the property under certain circumstances, namely, if applicable non-bankruptcy law permits the sale of such property free and clear of such interest, the nondebtor interest holder consents, the interest is a lien "and the price at which such property is to be sold is greater than the aggregate value of all liens on such property," the interest is in bona fide dispute, or the nondebtor interest holder could be compelled to accept a money satisfaction of the interest. Thus, under certain circumstances, if a debtor sells IP pursuant to Section 363, nondebtor licensees of the IP may find their licenses extinguished.

The most debtor-friendly creation of the U.S. Bankruptcy Code is the automatic stay, which, pursuant to Section 362, arises upon the filing of a petition for bankruptcy relief. This stays, among other things, the commencement or continuation of all judicial, administrative, or other actions against a debtor that were or could have been commenced prior to the bankruptcy, as well as any act to collect, assess, or recover a claim against the debtor, with certain enumerated exceptions. Bankruptcy judges typically apply the automatic stay broadly, which stays termination of an IP license agreement and possibly even provides notice of a default. In an effort to circumvent the automatic stay and bankruptcy process in general, parties to IP license agreements often draft their agreements to include default provisions triggered by the insolvency or commencement of a bankruptcy case by either party, but such "*ipso facto* clauses" generally are not enforceable in bankruptcy pursuant to Section 365(e).

Bankruptcy judges often punish violations of the automatic stay severely, so nondebtor counterparties to IP license agreements must be careful not to violate the stay. Accordingly, nondebtor counterparties embroiled in patent litigation, or

those contemplating the commencement thereof, would be advised to move for relief from the automatic stay to commence or continue such litigation, regardless of whether the nondebtor counterparty is licensor or licensee under the license agreement. Nondebtor counterparties may and often do seek relief from the automatic stay pursuant to Section 362(d) for cause, including lack of adequate protection of an interest in property, or where the debtor does not have equity in the property in question and the property is not necessary for an effective reorganization.

Because of the automatic stay, nondebtor parties to executory contracts are typically limited in what actions they can take relative to such contracts—even if the debtor is in breach of the contract—until the trustee or DIP decides to assume or reject such contracts. A trustee or DIP has the option to assume (i.e., honor) or reject an executory contract, such as an IP license agreement, assuming the parties have material obligations due and owing to each other. After a petition for bankruptcy relief is filed but before the trustee or DIP assumes or rejects an executory contract, the contract remains in existence, enforceable by *but not against* a debtor, on account of the automatic stay.

A nondebtor counterparty to an executory contract may move the court to compel the debtor to assume or reject its contract, although such motions are not typically granted, particularly in the early stages of a chapter 11 case. But if the debtor continues to receive benefits under the contract before it makes a decision to assume or reject the contract, then the debtor is obligated to pay the reasonable value of those benefits, which may be determined to be the amount specified in the contract. To assume an executory contract, the trustee or DIP must cure any default under the contract or provide adequate assurance of cure (with limited exceptions) and provide adequate assurance of future performance under the contract. If the trustee or DIP elects to assume the contract, it generally has the option to assign the contract to a third party.

Despite the fact that Section 365 grants a significant amount of leeway to debtors with regard to executory contracts, seemingly at the expense of nondebtor counterparties, there are certain balances built into this section of the U.S. Bankruptcy Code. Section 365(c)(1) provides that the trustee or DIP may not assume or

assign an executory contract if applicable nonbankruptcy law excuses the nondebtor party from accepting performance from or rendering performance to an entity other than the debtor or debtor-in-possession and the nondebtor party does not consent to such assumption or assignment. This provision is designed to protect licensors from being forced to license their IP to a party with which they did not contract absent their consent.

There is a split of authority among the courts of appeals as to whether Section 365(c)(1) prohibits a licensee from assuming an executory contract, and much of the litigation over this provision arises in the context of IP license agreements. Closely tracking the language of the statute, the courts of appeals in the Third, Fourth, and Ninth Circuits (and arguably the Eleventh Circuit) abide by the “hypothetical” test, prohibiting assumption of an executory contract by a licensee even if the debtor does not “actually” intend to assign it.<sup>6</sup> The First Circuit permits a debtor licensee to assume an executory contract if the debtor does not “actually” intend to assign it.<sup>7</sup> The Fifth Circuit has construed the language of Section 365(e)(2), which is substantially similar to that of Section 365(c)(1), in accordance with the “actual test,”<sup>8</sup> and bankruptcy courts in the Eighth and Tenth Circuits have applied the “actual test” in construing Section 365(c)(1).<sup>9</sup>

Should the trustee or DIP ultimately reject the contract, the contract is deemed to have been breached as of immediately before the date of filing the petition. This typically gives rise to a general unsecured claim with damages calculable under applicable state law. A counterparty to a rejected executory contract typically has 30 days after rejection to file a proof of claim pursuant to Section 501; rejection orders typically specify the deadline to file such claims. If a contract is assumed and later rejected, the breach is deemed to be at the time of rejection (i.e., post-petition), unless the case was converted to a chapter 7, in which case the breach is deemed to be immediately before the date of the conversion (i.e., post-petition, pre-conversion), though if the assumption itself takes place after conversion, the breach is deemed to be at the time of rejection (i.e., post-petition, post-conversion).

To the further benefit of creditors, claims are allowed unless a party in interest objects. Depending on the size of

the bankruptcy, trustees or DIPs may file omnibus objections to multiple claims for a given set of reasons enumerated in Rule 3007(d) of the Federal Rules of Bankruptcy Procedure. Thereafter, trustees or DIPs typically object to claims on a case-by-case basis, and attorneys often negotiate the terms upon which claims will be allowed, including the dollar amount and priority of such claims, though under certain circumstances, they may litigate these issues.

Nondebtor counterparties to executory contracts—specifically, IP license agreements—are given further flexibility

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## ***Nondebtor counterparties to executory contracts are given further flexibility by Section 365(n).***

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by Section 365(n), which provides that where the trustee or DIP rejects an IP license agreement under which the debtor is licensor, the nondebtor licensee may elect to treat the agreement as terminated if rejection amounts to a breach that would entitle the licensee to treat the agreement as terminated by its terms or under applicable nonbankruptcy law. Alternatively, the nondebtor licensee may elect to retain its rights under the agreement and any supplementary agreement for the duration of the contract and any extension right available under applicable law. These retained rights include the right to enforce any exclusivity provision but exclude any other right under applicable nonbankruptcy law to specific performance.

If the licensee elects to retain its rights under the license agreement, it must make all royalty payments due under the agreement for its duration. Further, the licensee is deemed to have waived any right of setoff it may have with respect to the agreement under the U.S. Bankruptcy Code or applicable nonbankruptcy law, and any priority administrative expense claim pursuant

to Section 503(b). In addition, when the nondebtor licensee elects to retain its rights, Section 365(n)(3) requires the trustee or DIP, upon written request by the licensee, to furnish to the licensee any IP (including any embodiment of the IP) held by the trustee or DIP and not interfere with the rights of the licensee as provided in the IP license agreement or any supplementary agreement, including any right to obtain such IP.

In sum, while the U.S. Bankruptcy Code provides trustees and DIPs with significant flexibility vis-à-vis nondebtor counterparties to IP license agreements, it does contain a number of protective balances.

### *U.K. Perspective*

Consistent with the United States, many license agreements in the United Kingdom include default provisions triggered by the insolvency of the licensee. However, the U.S. treatment of these provisions is quite different from that of the United Kingdom, where the termination of the license agreement is unlikely to be prohibited by the moratorium against creditor action that applies in U.K. insolvency proceedings. In addition, some license agreements include provisions whereby, in the event that one of the parties becomes insolvent, the IP transfers to the solvent party.

This position has recently come under scrutiny in *Butters v. BBC Worldwide Ltd.* [2009] EWHC 1954 (Ch), where BBC Worldwide (BBCW), the BBC's commercial arm, was successful in its dispute with the administrators of Woolworths Group, a retail chain that collapsed. The dispute concerned the appropriate basis on which to value Woolworths' shares in its 2Entertain joint venture on DVD and video distribution. BBCW had granted the joint venture a perpetual master license of rights over BBC content. Following the insolvency of Woolworths, BBCW served notice to buy out Woolworths' shares in 2Entertain. Under the relevant contractual provisions, BBCW was obliged to pay "fair value" for the shares, as determined by an independent valuer, and could terminate the master license. However, the administrators objected and cited the "deprivation principle" of insolvency law that certain provisions in the relevant agreements were void, obligating BBCW to buy the shares on the basis that the master license subsisted and had not been terminated and raising the price for the shares. Additionally, the administrators contended that the valuer's assessment of

fair value should take into account the fact that BBCW was obliged to buy Woolworths' shares. However, the administrator's challenges were unsuccessful, and the contractual position was honored.

Distinguishing the decision in *Perpetual Trustee Co. Ltd. v. BNY Corporate Trustee Servs.* [2009] EWHC 1912, the court found that the deprivation principle did apply, but it agreed with BBCW that the effect of the principle in the present case was only to avoid part of the relevant clause. The result was that the master license had terminated and the valuation was to be determined on that basis. The court also found that given the hypothetical basis of the assessment of "fair value" established by longstanding jurisprudence, it was not permissible to take into account the fact that BBCW was obliged to buy Woolworths' shares. The key lesson from this dispute is to ensure the agreement is balanced and fair—had BBCW been seen to take excessive advantage, the court may not have found as it did.

If the IP is not critical to the debtor, a liquidator may consider disclaiming a license as onerous property. Section 178 of the U.K. Insolvency Act 1986 confers on liquidators the power to disclaim onerous property, which is defined as "any unprofitable contract, and any other property of the company which is unsalable or not readily saleable or is such that it may give rise to a liability to pay money or perform any other onerous act." An IP license, which may be of limited value to creditors but requires the insolvent company to pay a license fee is, potentially, an onerous contract. However, where a license agreement is disclaimed, the counterparty, assuming it has suffered a loss, would become a creditor of the debtor to the extent of the loss. If a licensor debtor disclaims a license agreement, the licensee would retain the right to use any licensed IP, as the disclaimer only operates to release the insolvent company from its obligations and does not affect the rights of the licensee. Furthermore, where a liquidator disclaims registered IP, an entity with an "interest" in the IP (e.g., an exclusive licensee) can appeal to the court to have the IP vested in it. It should be noted that only a liquidator may disclaim onerous property. However, an administrator can cause a debtor to breach the terms of a license and allow the counterparty to file a suit to recover damages, which, if successful, would become an unsecured creditor's claim.

A common issue arising in the United Kingdom is the identification of unregistered IP and its valuation. Typical scenarios involving IP are either the desire of a licensee to maintain its rights or the desire of those with a security interest over the IP to ensure the insolvency practitioner/administrator or liquidator does not dispose of the underlying IP without their being able to claim their entitlement. As mentioned earlier, IP may have been used for security, and it is important to check whether the charge/security interest has been registered at Companies House, because any security that is not registered is void against a liquidator or an administrator per section 874 of the U.K. Companies Act 2006. It is of equal importance to check the national registry for IP at the U.K. Intellectual Property Office (IPO) to determine what interests, if any, against the IP are registered. This can be very important, as failure to register with the U.K. IPO can have significant impact on rights and the ability to bring infringement actions or recover costs and may affect title. Patent licenses in particular should be registered at the U.K. IPO, as failure to do so can have cost consequences. For example, under Section 68 (Patents Act 1977) a proprietor or an exclusive licensee may not be able to obtain damages or an account of profits in an infringement action where a registration does not occur. Additionally, unlike in the United States, the United Kingdom does not have established protection for licensees who continue to make payments under their license, and whether the license under which they operate will be maintained is a primary concern.

### **Conclusion**

The importance of intangibles to the market value of companies will likely continue to result in high-stakes, "bet-the-company" litigation in the United States, United Kingdom, and other foreign jurisdictions. Accordingly, the threat of insolvency, whether real or perceived, may be pursued by a party in a licensing dispute as a mechanism to resolve the proceedings. A basic understanding of the laws governing IP license agreements in insolvency can provide a mechanism for assessing the risks associated with the threat of insolvency and the potential outcomes of the litigation. Although some similarities exist, the laws governing IP license agreements in insolvency are markedly different between the United States and the United Kingdom. As

such, the complexity related to IP license agreements in insolvency is further amplified given the differences in insolvency law in foreign jurisdictions. ●

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## Endnotes

1. WORLD INTELLECTUAL PROPERTY ORGANIZATION, WIPO STATISTICS DATABASE, JUNE 2009, <http://www.wipo.int/ipstats/en/statistics/patents/> (last visited May 14, 2010).

2. Nakamura, L.I., *What Is the U.S. Gross Investment in Intangibles? (At Least) One Trillion Dollars a Year!* (Federal Reserve Bank of Philadelphia, Working Paper No. 01-15).

3. See 11 U.S.C. § 101, *et seq.* Debtors and creditors are also governed by other nonbankruptcy laws and state common law, which are not addressed in this article.

4. Congress has amended the U.S. Bankruptcy Code several times since 1998, with the most recent significant amendments arising under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

5. It is generally agreed that an executory contract is one under which both parties have material obligations due and owing to each other, though the U.S. Bankruptcy Code does not define “executory contract.”

6. See *In re West Elecs., Inc.*, 852 F.2d 79 (3d Cir. 1988); *RCI Tech. Corp. v. Sunterra Corp.* (In re Sunterra Corp.), 361 F.3d 257 (4th Cir. 2004); *Perlman v. Catapult Entm’t* (In re Catapult Entm’t), 165 F.3d 747 (9th Cir. 1999), *cert. denied*, *Catapult Entm’t, Inc. v. Perlman*, 528 U.S. 924 (1999).

7. See *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1997), *cert. denied*, 521 U.S. 1120 (1997).

8. See *Bonneville Power Admin. v. Mirant Corp.* (In re Mirant Corp.), 440 F.3d 238 (5th Cir. 2006).

9. See *In re GP Express Airlines, Inc.*, 200 B.R. 222 (Bankr. D. Neb. 1996); *In re Aerobox*, 373 B.R. 135 (Bankr. D.N.M. 2007).