A BANKRUPTCY REMOTE ENTITY MAY BE ONE WAY TO AVOID RISKS FOR LICENSEES

THE INTERACTION between bankruptcy law and intellectual property licenses continues to pose many difficult problems. The conflicts are inevitable because the U.S. Bankruptcy Code is focused on reducing obligations on the estate of the debtor in order to maximize the value of the assets that will be available to reimburse the debtor's creditors. One of the most important powers under 365 of the Bankruptcy Code is the right to reject executory contracts, essentially terminating such agreements.

Ironically, the critical term in this section, executory contract, is not defined in the Bankruptcy Code, but was defined in a seminal article by Professor Vern Countryman: An executory contract is any agreement that contains materially unperformed obligations on both parties where the failure to perform would constitute a material breach. Vern Countryman, Executory Contracts in Bankruptcy: Part I, 57 Minn. L. Rev. 439, 460 (1972-1973). Most intellectual property licenses are executory contracts since they include obligations on the licensee to pay royalties or report its sales, and the licensor has obligations such as providing indemnification or technical assistance.

Prior to Congress' enactment of 365(n) of the Bankruptcy Code, the licensor's ability to effectively terminate a license agreement upon rejection of the license as an executory contract left licensees with uncertain license rights, which was particularly problematic when licensees prepaid royalties or took other action in reliance on their continued license rights. Section 365(n) was enacted in response to the problem, which was highlighted in In re Richmond Metal Finishers, 756 F.2d 1043 (1985) (Lubrizol), a case in which the licensee, Lubrizol, lost its nonexclusive trade secret license when the licensor, Richmond Metal Finishers, rejected the license.

Section 365(n) provides a licensee with two options: treat the rejection as a material breach under 365(n)(1)(A) and terminate the license agreement, or elect to retain its license under 365(n)(1)(B) with certain modifications. In the first option, the licensee loses its license to the intellectual property but obtains a general unsecured claim for damages. Generally, licensees receive very little payment as unsecured creditors and lose the most important right, the right to use the intellectual property. In the second option, the licensee retains a license with the same rights as they existed on the date of the bankruptcy petition but
these rights extend to a specific definition of intellectual property, which in many cases may be more narrow than what the 
licensee originally negotiated, and all future obligations (such as indemnity, new developments and technical assistance) are 
terminated, though the licensee must continue to pay all royalties under the license.

Essentially, 365(n) grants a new, statutorily defined license. This article focuses on the impact of the specific definition of 
intellectual property under 365(n) and a structure to minimize the impact on the licensee.

Intellectual property is defined in the Bankruptcy Code to include mask works, copyrights and patents arising under the specific 
sections of U.S. law as well as patent applications and trade secrets without any geographic distinction (trademarks were 
expressly excluded). Intellectual property is based on national laws, so a company does not own a patent but rather owns a 
patent under the laws of a particular country, which may differ in important ways ranging from the scope of the rights to their 
term. Consequently, the definition of intellectual property in the Bankruptcy Code, by its terms, appears to exclude copyrights 
and patents arising under foreign laws.

Though the issue has never been litigated, it is likely that the licensee's new statutory license pursuant to 365(n) (1)(B) would 
not include a license to foreign patent and copyrights. The licensing of technology has increased dramatically in importance as 
well as the global nature of licensing. It is difficult to measure the total value of licensing in the economy, but a recent survey 
conducted by the Association of University Technology Managers of technology licensing by 222 U.S. and Canadian 
universities, hospitals and research institutions, indicated that the value of technology licenses has increased sixfold between 
of technology licensing, together with the interconnected nature of the current global economy, makes this limitation of the 
statutory license under 365(n) a significant problem.

The use of BREs

The most certain method of avoiding this risk is for the prospective licensee to take an assignment to the intellectual property 
and license it back to the original owner. However, this option is rarely available because the licensor views such an approach 
as a sale rather than a license of the intellectual property. Therefore, the most effective method for licensees to avoid the 
potential negative consequences for foreign rights resulting from a bankruptcy of the licensor (also referred to in this article as 
the parent) may well be the creation of a bankruptcy remote entity (BRE) to become the owner and licensor of the intellectual 
property.

The BRE is designed to avoid both a voluntary or involuntary bankruptcy case. Since the adverse consequences that could 
result from the rejection of the licensee's license would occur only if the licensor was the debtor in a bankruptcy case, by 
making a BRE the licensor with little chance of becoming a debtor, the risk that the adverse consequences would occur is 
minimized. A licensee may have leverage to convince a licensor to make a BRE the licensor if the licensee will do the deal 
only under that condition.

BREs have been more commonly used in the real estate area and their use remains novel and relatively unknown in the area of 
technology licensing. Typically, a BRE is structured as a corporation, frequently a Delaware corporation since Delaware's body 
of corporate law is relatively well developed and generally provides greater assurance and guidance in understanding and 
analyzing legal issues. Though a Delaware business trust or limited liability company are also possible structures for the BRE, 
the disadvantages of using either of these entity structures outweigh their advantages.

BREs structured as corporations need to include operational covenants in the charter documents to ensure the separate legal and 
operational existence between the financially distressed parent and the BRE. This separate existence is necessary to minimize 
the risk that the BRE becomes a debtor itself and the risk of involving the BRE in a bankruptcy of the parent through 
substantive consolidation.

Substantive consolidation is a judicially created equitable doctrine that, among other matters, allows a bankruptcy court the 
discretion to exercise jurisdiction over assets of a nondebtor party. Courts most often order substantive consolidation when the 
nondebtor party is found to be an alter ego of the debtor, so the charter provisions should require that the BRE conduct itself in 
an independent manner so as to avoid the alter-ego determination.
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Some examples of the actions that the BRE should be required to take include establishing and maintaining an office through which the BRE's business would be conducted separate and apart from those of the parent, as well as a fair and reasonable allocation of any overhead of shared facilities; maintaining separate corporate records and books of account from those of the parent; not commingling assets with those of the parent; and conducting business in the name of the BRE rather than the parent.

To avoid a voluntary bankruptcy, the licensee should insist that it becomes a stockholder of the BRE with a veto over certain transactions. The licensee would typically purchase and hold a few shares of a class of stock with no rights other than a class vote on certain transactions, including the initiation of a bankruptcy case, a disposition of the intellectual property and any change in control. This stock would not have any rights to dividends, liquidation preferences or any other economic rights. This approach provides the licensee with a veto, but because it holds only a few shares, the licensee minimizes its liability from exercising its veto rights since it does not have the fiduciary duties typically associated with majority stockholders.

In addition to the protections afforded from becoming a stockholder, the licensee can also require that its stock comes with the right to vote for a single director on the board of directors. The charter would, then, require that no bankruptcy petition, disposition of intellectual property or change of control could be authorized without the affirmative vote of that director. In addition, the BRE's charter should also require that the BRE's board of directors include at least one disinterested director with no affiliation to the parent or licensee, and provide that no bankruptcy petition, disposition of intellectual property or change of control be authorized without the affirmative vote of that director.

The protections at the board of directors level are supplemental to those afforded the licensee through its stock ownership because the directors may still decide that their fiduciary duties require them to vote in favor of one of these actions. Therefore, the licensee's position as a stockholder with a veto vote of a class of securities described above provides more certainty in preventing a BRE's voluntary bankruptcy.

To avoid the risk of involuntary bankruptcy, the BRE should also be bound by operational covenants that restrict the BRE's ability to incur liabilities to minimize the risk that third parties would have the right to bring an involuntary bankruptcy petition against the BRE. Some examples of these types of covenants include not guaranteeing or otherwise becoming obligated for debts of other entities; not pledging its assets for the benefit of any other entity; and not engaging in any material business activity, other than bare licensing of technology (i.e., without providing indemnification or other obligations), that could give rise to monetary liability and, thus, creditors.

Though it is not practically or legally possible to totally eliminate the possibility of creditors of the BRE (for example, as the owner of intellectual property, the BRE will need to hire attorneys to prosecute its patent portfolio and those attorneys will be creditors of the BRE), these covenants minimize the BRE's ability to incur liabilities not essential to the bare licensing of technology.

Assignment of rights

In order for the BRE to grant the license to the licensee (and potentially other licensees), the BRE must have the necessary rights to the intellectual property. Thus, the parent must assign to the BRE ownership of the relevant intellectual property. Section 365(n) expressly provides for the retained license to include U.S. copyrights and U.S. patents, so the parent could elect to assign to the BRE only ownership of the foreign copyrights and patents. Then, the licensee's rights to the foreign rights would come from the BRE and the rights to the U.S. rights would come from the parent. However, given the uncertain future of the parent after the filing of a bankruptcy, the licensee would benefit if it received all rights under the license from the BRE, which would require an assignment to the BRE of the U.S. rights as well as the foreign rights.

While the establishment of a BRE is likely to decrease significantly the risks associated with reliance on the statutorily defined license of 365(n), there are risks and limitations associated with the assignment of intellectual property from the parent to the BRE to effect the structure. First, an assignment of a patent may limit the ability of the parent to obtain monetary damages (rather than injunctive relief) under U.S. patent law.

Second, the parent may not be able to transfer all of its IP to the BRE because some of its IP may be in the form of third-party licenses that require the consent of the third-party licensor. Therefore, though the BRE may be able to acquire ownership, and
then license, much of the parent's IP, the BRE's rights, and thus the licensee's license from the BRE, may not include thirdparty rights, which may be necessary or essential.

Finally, the transfer of intellectual property from the financially distressed parent to the BRE may, after the parent files bankruptcy, be avoided as a fraudulent transfer under 544 or 548 of the Bankruptcy Code based on the argument that the parent did not receive reasonably equivalent value in exchange for the transfer. However, the license from the BRE to the parent discussed above may be used to show that the parent received equivalent value. The royalties need to be reasonably allocated between the two licenses and the licenses containing appropriate setoff provisions to avoid double payment of royalties. The licensee and parent could also agree to obtain a fairness opinion for the transfer of intellectual property.

**Two forms of licenses**

In most cases, the parent will insist on the ability to grant licenses itself under its own name rather than that of the BRE for licenses in the ordinary course. The license from the BRE would be used as a backup if requested by a licensee. To accommodate this goal, the BRE and parent generally enter into a separate license agreement in which the parent obtains a license from the BRE that includes the right to sublicense to third parties. Since the license from the BRE will be a bare intellectual property license without indemnification or similar provisions that could lead to monetary liability, the licensee will generally have two parallel licenses: a bare intellectual property license from the BRE and a more traditional sublicense from the parent with indemnification and other provisions.

The BRE structure requires a carefully coordinated set of documents: BRE charter documents, intellectual property assignment from parent to BRE, license agreement between BRE and parent, license agreement between BRE and licensee and license agreement between parent and licensee. In considering whether a BRE structure is appropriate for a particular license, one must weigh the risks and limitations of the structure, together with the time and expense needed to establish one, against the uncertainty of relying on the retained license rights of 365(n) alone.

While establishing a BRE may not be a viable solution to every intellectual property license when the licensor is financially distressed, certain factors surrounding the license may weigh heavily in favor of the need for the greatest certainty of retaining license rights in foreign countries. These factors include those licenses in which the foreign rights are important to the licensee, either because of the licensee's manufacturing site or the potential market for products; the licensee's need to retain rights to trademarks that are expressly excluded from 365(n); and significant up-front payments under the license or investment in the rights through construction of manufacturing facilities, the value of which may be lost if the license rights are lost. The licensee should also consider under which conditions it would be willing to terminate the BRE if a more solvent company merges with the parent or purchases the assets of the parent.

Although 365(n) has been perceived as a solution for licensees since its enactment, the statute provides, at best, an incomplete solution in today's global economy where the rights in foreign countries are as, or in some cases, more important than those rights in the United States. While the legal issues surrounding the use of BREs in intellectual property licenses have not been tested in court, the BRE structure provides one of the only practical alternatives to the uncertainty of 365(n) with respect to foreign intellectual property rights, and licensees should consider a BRE in order to maximize the preservation of their license rights.

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