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Structuring Grants of Intellectual Property Rights in Cross-Border Transactions to Avoid Loss of Rights in the Event of Bankruptcy

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As a consequence of an anomaly in the laws of many countries, companies that acquire intellectual property rights ("IPR") held by a non-United States entity by means of a license may lose such rights if the non-United States entity goes into bankruptcy and the bankruptcy trustee (or equivalent) terminates the license. Fortunately, however, the risk of this result, which from the perspective of an intellectual property lawyer and likely many business people is both astonishing and unjust, can be mitigated by structuring grants of IPR from non-United States licensors with this risk in mind.

Background

The anomaly is that an intellectual property license is generally treated as an executory contract with obligations that are yet to be performed, in some cases even if the license fees have been paid in full and the only outstanding obligations are contingent ones such as indemnifying the licensee for damages if there were an infringement suit by a third party. Under many countries' bankruptcy laws, executory contracts can be terminated by the bankruptcy trustee (or equivalent) if such termination is in the interests of the bankrupt licensor's creditors.

If the license agreement is terminated, the licensee may have to stop using the licensed intellectual property, unless the licensee can obtain the right to continue using the intellectual property, at additional cost, either through a new license or by purchasing the intellectual property outright. If the licensee continues to use such intellectual property despite termination of the license, such use is likely to constitute unlawful infringement.[1]

Other than with respect to trademark licenses, this problem generally no longer exists in the United States. Under section 365(n) of the Bankruptcy Code, licensees of patents, copyrights, and trade secrets are generally protected from losing their licenses as a result of the licensor's bankruptcy so long as the licensor is a United States entity.

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If the licensor is not a United States entity, however, section 365(n) is inapplicable, even if the IPR are registered in the United States (*e.g.*, United States patents); applicable law will be the law of the country (or a jurisdiction within the country) where the licensor is incorporated or otherwise organized. As of the writing of this article, among major commercial jurisdictions, neither the United Kingdom nor Germany has enacted a law that is equivalent to section 365(n).[2] Canada's parliament has passed legislation similar to section 365(n), but such legislation does not have the force of law. Under Japanese law, to the extent that licenses of patents, trademarks or other limited categories of IPR have been registered with the government, such licenses are protected under a general provision in Japanese bankruptcy law for protection of perfected rights arising from an executory contract - however, similar protection is not available for copyrights and trade secrets (which are not registrable in Japan) or for licenses that have not been registered with the government.

Structuring Grants of IPR to Avoid Loss of Rights

In countries without protection equivalent to section 365(n), in many cases it is nevertheless possible to protect a licensee from losing its rights in the event of the licensor's bankruptcy if the grant of IPR is properly structured.

Given that the problem arises in the law from the fact that a license is treated as a contract rather than as a property right, one approach is to structure the transaction as an assignment of the IPR rather than a license of them (if necessary with a license back from the assignee for such uses as the assignor has a continuing need). An assignment is the transfer of a property right, and this property right generally cannot be taken away in connection with the assignor's subsequent bankruptcy.[3]

An obvious problem with this approach is that the owner of the IPR may be reluctant to assign such IPR. In some cases, however, the owner of the IPR may be persuaded to assign a partial interest in the IPR even if it is unwilling to assign its entire interest. Many countries (*e.g.*, Canada) recognize assignments of certain IPR that are limited to a specific field of use or territory. Accordingly, in place of a field of use-limited exclusive license (*e.g.*, an exclusive license in the optical networking field), the parties could agree that the owner of the IPR will assign all IPR within a particular field, while retaining all other rights (*e.g.*, an assignment of all rights in the IPR in the optical networking field only). Note, however, that not all countries recognize field of use-limited assignments with respect to each of the major categories of IPR (*e.g.*, patents, copyrights, and trade secrets). For example, Canada recognizes such partial assignments of patents, but not trade secrets; in such case this

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approach would work for the patents, but another approach would be necessary for the trade secrets.

A second approach is closely related to the first: in place of a license, have the licensor assign a joint ownership interest in the relevant IPR. The advantage for the assignee is that, because the joint ownership interest is a property right, it is generally not subject to being taken back in the event of the assignor's bankruptcy.[4] In most cases, the owner of the IPR will desire to place conditions and restrictions (*e.g.*, territorial restrictions) on the assignee's use of the IPR. This can be done by means of a contract between the assignor and assignee. The contract, however, being only a contract, suffers from the same problem as a license would in that, under certain circumstances, it could be terminated in the event of a bankruptcy.

The good news for the assignee in such case is that, given that it has been assigned a property right, it is unlikely to lose its continuing right to use the IPR. Rather, if the contract is terminated, whatever conditions and restrictions the parties have negotiated into the contract are likely to be lost. For example, if the contract stated that the assignee's rights were exclusive in the optical networking field of use in North America and the assignor's rights were exclusive in such field everywhere else, and if the contract were subsequently rejected, both parties would be free, as between themselves, to use the relevant IPR everywhere, without regard to territorial restrictions.

Instead of depending upon an assignment, rather than a license, of the IPR, a third approach involves the grant of a license by a bankruptcy-remote affiliate of the operating entity. This can be done in two ways. The first is to have the licensor assign the IPR to a bankruptcy-remote special purpose entity ("SPE") (*e.g.*, a separate legal entity with no ability to take on debts), which then grants the licensee the license. The second is to have the licensor assign the IPR to a separate legal entity that is organized in the United States or another country with section 365(n)-like protection, and then have that legal entity grant the license. Because it is highly unlikely that a SPE will ever go into bankruptcy, the issue of protecting the licensee's rights in the event of the licensor's bankruptcy does not even arise. Even if the new entity were to go into bankruptcy, if such entity were established in a country with section 365(n)-like protection, the licensee's IPR should be secure.

Note, however, two important considerations regarding this approach are that: (1) there may be tax consequences to intra-company and cross-border IPR assignments, and (2) bankruptcy experts advise that there is a risk that a bankruptcy court would fail to respect

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the independence of an SPE affiliated with a bankrupt company if by not respecting such independence, the value of the bankruptcy could be obtained increased.[5]

Conclusion

Licensors typically resist all of the approaches. Therefore, a licensee will likely need to possess and exert significant leverage in order to convince a licensor to agree to any of the approaches. Nevertheless, the risk to a licensee of accepting a mere license for critical IPR from an entity based outside the United States (or another country with section 365(n)-like protection) is considerable, and companies with a need for such IPR are well-advised to take this risk into account, as well as the above methods of mitigating it. Of course, the discussion contained in this article is general in nature, and the law in this area is in flux. Thus, it is essential to consult with an experienced practitioner to determine how to apply the approaches outlined above with respect to specific IPR and jurisdictions.

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[1] *See Raima UK Ltd. v. Centura Software Corp.*, 281 B.R. 660,674-675 (Bankr. D. N. Cal. 2002) (holding that with respect to trademarks, which are excluded from the protections of section 365(n), a trademark holder is not entitled to retain any rights to trademarks under a rejected trademark license agreement).

[2] In April 2010, an official at the Ministry of Justice in Germany stated that there were plans to address the issue of how a licensor's insolvency affects the licenses it has granted, but that there was no draft yet of legislation or a concrete time schedule to enact such legislation.

[3] Assuming, that is, that the assignor was solvent when the assignment was made; did not make the assignment to hinder the claims of creditors; did not become insolvent, or leave itself with unreasonably little capital to continue operations, as a result of the assignment; did not make the assignment for less than fair market value; and did not in assigning the IPR to a creditor place that creditor in a better position than other creditors. *See generally*, the Uniform Fraudulent Transfer Act, which has been adopted in most of the United States, as well as section 548 of the Bankruptcy Code. Note that while assignments and licenses of intellectual property are generally distinct, *i.e.*, a transfer of intellectual property is either an assignment or a license but not both, some exclusive licenses that transfer all the incidents of ownership may be deemed to be assignments of a property right. *See, e.g.*, Euro-Excellent Inc. v. Kraft Canada Inc., [2007] 3 S.C.R. 20.

[4] *See supra* footnote 3.

[5] See F. Scott Kieff and Troy A. Paredes, *An Approach to Intellectual Property, Bankruptcy,*

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and Corporate Control, 82 Wash. U. L. Q. (2004) (noting that many licensees negotiate for their licensor to transfer the licensed assets to an SPE to reduce the risk that the debtor-licensor will reject the license as an executory contract, but also citing a case holding that a debtor that had transferred non-IPR assets to an SPE nevertheless had "at least some equitable interest" in the assets and that such interest constituted a property right (*In re LTV Steel Co., Inc.*, 274 B.R. 278 (Bankr. N.D. Ohio 2001)). *See also* Delaware's Asset-Backed Facilitation Act, Del. Code Ann. tit. 6, § 2701A – 2703A (Supp. 2004). The Asset-Backed Facilitation Act bolsters protection of the assets of SPEs from creditors of the transferor of such assets, stating that:

> A transferor in the securitization transaction, its creditors or, in any insolvency proceeding with respect to the transferor or the transferor's property, a bankruptcy trustee, receiver, debtor, debtor in possession or similar person, to the extent the issue is governed by Delaware law, shall have no rights, legal or equitable, whatsoever to reacquire, reclaim, recover, repudiate, disaffirm, redeem or recharacterize as property of the transferor any property, assets or rights purported to be transferred, in whole or in part, by the transferor.

Id.

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