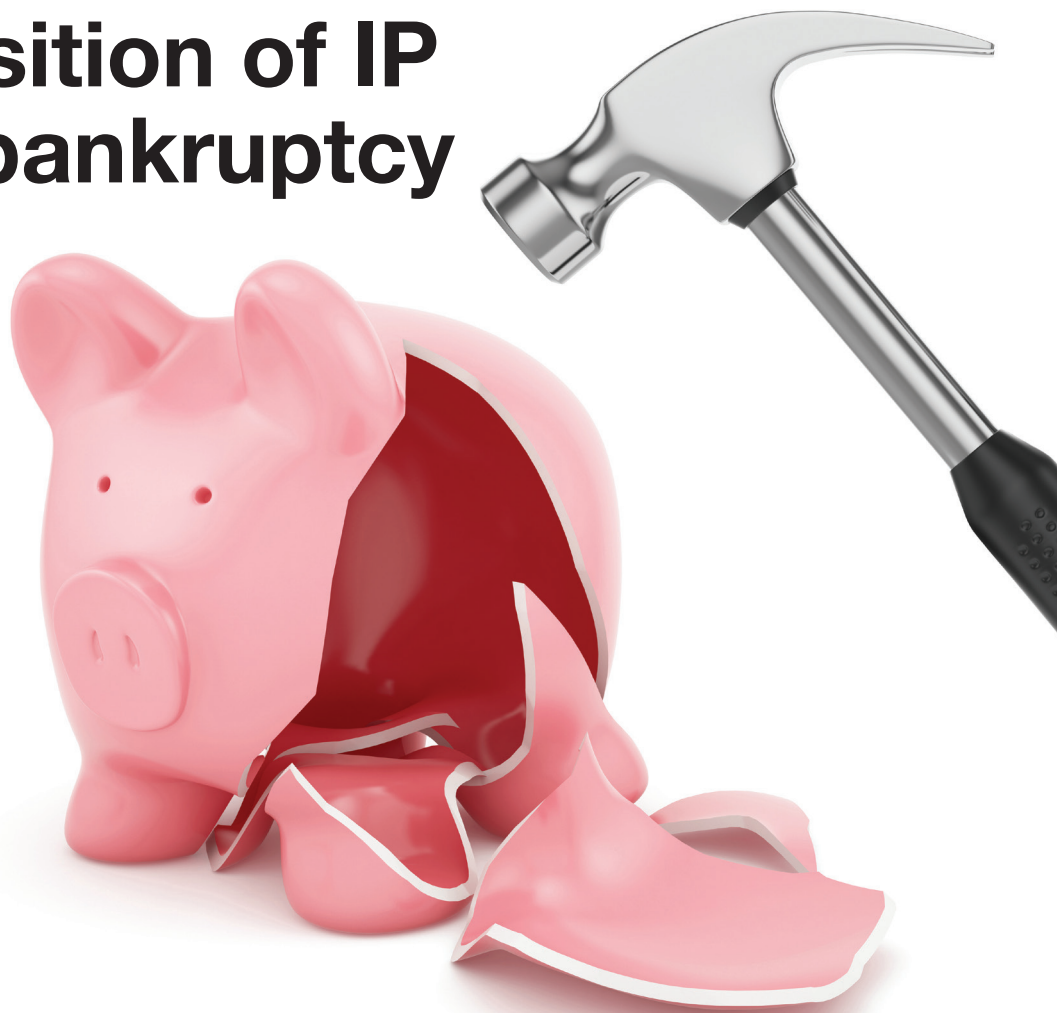


# The acquisition of IP assets in bankruptcy

The sale of IP assets during a bankruptcy can be a very lucrative transaction for both buyer and seller, but what due diligence needs to be considered? Shearman & Sterling's **Samuel Waxman**, **Michael Jokic** and **Brooke Schachner** review



IP assets are often a distressed company's most valuable items. The sale of IP can raise significant cash for the future plans of a reorganising debtor or for the creditors of a liquidated estate. For buyers, acquiring IP through bankruptcy can be advantageous, as the assets are typically acquired free and clear of liens<sup>1</sup> and claims and often can be purchased at 'fire sale' prices. For the uninitiated, or those unfamiliar with the complexities of the US bankruptcy process, there are potential hazards involved in this type of transaction. Careful diligence and an understanding of the law can help assure the maximum value in these transactions.

There are two types of sellers in a bankruptcy; those who are seeking to reorganise and those being liquidated. Reorganising firms have an opportunity to shed non-core assets to raise cash. For example, Eastman Kodak sought to emerge from bankruptcy as a printer technology firm and as such, sold its digital imaging patent portfolio - valuable but not core to the firm's future focus - for \$527m. For Nortel, on the other hand, the sale of its crown jewel patent portfolio was the last in a long string

of liquidation sales. Nortel took advantage of a robust live auction in order to pit large technology firms like Google, Apple and Intel against each other and raised \$4.5bn.

Encumbrances, or in the case of IP, licences, often dictate the value of IP assets. In general, assets are sold in a bankruptcy proceeding "free and clear of any interest... of an entity other than the estate", which typically includes liens, encumbrances and claims. Accordingly, for a debtor, a key feature of the US Bankruptcy Code (the "Code") is the power to assume, assign, or reject so-called executory contracts, ie, those contracts for which substantial performance obligations exist for both parties, and a breach by either party would be considered material, thereby excusing the performance of the other party. Reorganising debtors will look to reject contracts they do not need or want, and both reorganising and liquidating debtors will seek to reject encumbrances that burden assets they wish to sell. Under Section 365(a) of the Code, a debtor, with the approval of the court, can effectively choose which executory contracts it wishes to live with going forward by assuming or rejecting any executory

contract. Assumption means that the debtor chooses to be bound by the terms of the agreement, while rejection of the contract allows the debtor to effectively walk away from the agreement, leaving the other party with an unsecured claim for damages against the bankruptcy estate. Finally, assignment of the contract involves the debtor transferring his or her obligations to another party.

IP licences (and covenants not to sue) are largely considered executory contracts, the rejection of which might have an extremely detrimental effect on a licensee who depends on access to the licensed intellectual property. Accordingly, pursuant to Section 365(n), the Code offers unique and specific protection to non-debtor licensees. If the licence is rejected, the licensee may choose to treat the contract as terminated and deal with the breach under applicable non-bankruptcy law or to retain its rights under the licence. In the event that a licensee decides to retain its rights, then the licensee's access to the licensed IP will continue, so long as the licensee continues to make royalty payments due or otherwise perform under the contract. Note that trademark licences are not covered by Section

365(n) and thus, can be rejected without the licensee being afforded the protections otherwise granted by the Code, a powerful distinction for those seeking to buy and/or sell valuable brands out of bankruptcy.

Buyers should be aware of the aforementioned unique limitations that the Code places on the ability of debtors to sell IP free and clear of pre-existing licences and covenants not to sue. While a buyer can take comfort in the fact that the bankruptcy proceedings will clear any claims to ownership of the acquired assets, they may very well be stuck with pre-existing licensees. In the case of a liquidation, a buyer should expect that the debtor-seller will reject all contracts that the buyer does not specifically ask to have assigned to it. In the case of a reorganisation, the debtor-seller may be assuming (keeping) licences that apply to multiples parts of its business and which encumber more than just the assets being acquired. Buyers should be aware of the rights, obligations, and covenants that they are willing to (or want to) take on through a purchase agreement. The considerations a buyer has may vary depending on its desired use of the underlying IP, but because of the stringent requirements set forth by the Code, all buyers should conduct diligence on licences. Through due diligence, a buyer should assess what exclusive or non-exclusive licences and other contractual obligations a debtor may have, and should seek to take on the minimum encumbrances that the law requires, ie, a licensee's rights under Section 365(n). In this context, buyers should recall that Section 365(n) only covers the grant of a licence or covenant not to sue, and does not extend to other commercial covenants which may appear in a licence agreement. Examples of which include agreements to maintain and enforce the IP, and options to renew. Where possible, buyers should either seek to have such agreements rejected, and should ensure that the purchase agreement does not have them assuming any of the liabilities or obligations associated with them. Where a buyer is compelled to take on obligations, it should be careful to limit them to those only the new owner of the intellectual property can perform and not commercial obligations generally. Finally, buyers should make sure that the seller-debtor is not left with the ability to extend, renew or amend any retained licences without the buyer's consent. Buyers of patents should also be diligent as to whether they are subject to the commitments of any standard setting organisation which could involve restrictions on licensing; the assumption of such commitments typically cannot be avoided under relevant competition law.

In some cases, a buyer may wish to acquire

the debtor's pre-existing revenue stream associated with the IP it is acquiring through the assignment of royalty-bearing licences. The debtor's ability to assume and assign agreements is limited by the bankruptcy code; a debtor may not assume and assign any executory contract if applicable law excuses the non-debtor party (the licensee) from accepting or rendering performance to any entity other than the debtor. Applicable law in this case means whatever law governs the IP at issue. Again, buyers should carefully review any agreements they wish to acquire, paying close attention to the assignment provisions. In the case of a rejected licence, a buyer should be aware that any royalties owed in the event that the licensee decides to retain its rights will be tied to the licence and not the purchased IP. Accordingly, they will remain with the debtor unless the parties specifically negotiated otherwise.

### “There is some debate as to whether or not foreign assets are afforded the protection of Section 365(n) because of the current definition of ‘IP.’”

#### Foreign IP assets

Acquiring assets in bankruptcy can become even more complicated when US debtors own foreign IP assets. There is some debate as to whether or not foreign assets are afforded the protection of Section 365(n) because of the current definition of “IP.” The Code defines IP, specifically copyrights and patents, as certain inventions or processes or works that would be protected under US Code. Using a very narrow definition, this might not include US owned foreign assets.

However, copyright law in the US allows for protection of foreign works - when there is a treaty in place with the country of origin for reciprocal protection or when the work was first produced in the US. Presumably, if the works are protected under the Copyright Act, then they would fall under the definition of IP in the Bankruptcy Code.

Further, there are added concerns when a foreign debtor owns US assets or when a foreign proceeding might affect a US creditor.

In this case, the parties should look at Chapter 15 of the Code, which was enacted to enhance cooperation between US and foreign courts. Under Chapter 15, US courts can bind entities to the terms of foreign proceedings or ensure that the protections provided under the Code will remain even when they are at odds with another country's bankruptcy provisions. This was the case in *In re Qimonda AG*,<sup>2</sup> in which the US Court of Appeals for the Fourth Circuit upheld the application of Section 365(n) in a German proceeding. The holding here stated that the bankruptcy court was correct in applying a “balancing of interests” test and finding that the interests of the patent licensees secured by Section 365(n) outweighed the interest of the debtor in canceling the licenses under German law. In the event of a sale, a US buyer should be aware that, through Chapter 15 filings, provisions of the Code may still stand even when a seller's home country does not afford licensees with the same protections.

#### Summary

While the special circumstances in the bankruptcy code were enacted to provide protection to licensees doing business with insolvent entities, they present potential pitfalls to those looking to purchase IP assets. These prospective buyers should always remain aware of these would-be snags and conduct thorough diligence before tying themselves to unknown encumbrances. Once this task is performed, however, the sale of IP assets during a bankruptcy can be a very lucrative transaction for both buyer and seller.

#### Footnotes

1. A lien is a form of security interest or other encumbrance granted over an item of property, often to secure payment of debt.
2. *Michael Jaffé v Samsung Elecs Co, Ltd and Ors.*

#### Authors



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