

• Making sense of the law

Bankruptcy and the Continuation of Business as Usual

BY AMY B. GOLDSMITH, ESQ. AND JEFFREY L. ZIVYAK, ESQ.

When a business files a petition to reorganize under Chapter 11 of the Bankruptcy Reform Act, or files for bankruptcy under Chapter 7, what options are available to the entities who deal with them? Licensors (those granting a license to sell or distribute exclusive goods designed and/or manufactured by the licensor's company) and licensees (those granted the license to do so) may both be particularly hard-pressed financially when such actions take place, and the need to be aware of the "rules" is essential to ensure the continuation of business as usual. In this column, we'll acquaint you with some of the ins and outs of bankruptcy, with a special focus on intellectual property concerns.

Background

The Bankruptcy Reform Act of 1978 and revisions governs all contracts. In its original form, licensing of traditional intellectual property (patents, trademarks and copyrights) and trade secrets and scientific know-how were given no special treatment. This created great problems. For instance, in one case, a bankrupt licensor was permitted to reject an existing license, leaving the licensee, who had built a factory to use the licensed scientific know-how, unable to continue doing business. Thus, in 1988, Congress enacted the DeConcini Act, which gave special treatment to trade secrets; an invention, process or design protected under the patent laws (either the subject of a pending patent application or issued patent); and copyrights. (Conspicuously missing: trademarks).



The Licensee's Rights

The rights provided by the new statute are significant and dramatic. Unlike the original Reform Act, the licensee was given the

Once again, Amy B. Goldsmith, a partner of regular columnist George Gottlieb, who specializes in intellectual property, contributes her expertise to the topic.

ability to continue to do business with the licensor. If a licensor files a petition for reorganization under Chapter 11—or even eventually winds up in Chapter 7—the licensee need not lose the merchandising rights granted under the license. The licensee has the option of accepting the licensor's rejection of the license and treating it as a material breach of the license agreement or electing to keep the license. Indeed, the license need not have started to run for the licensee to retain its rights if that election is made. The licensee is required to make timely royalty payments and is entitled to enforce the agreement as it stood at the time of the bankruptcy. The new section does not permit the licensee to call on the licensor for additional performance, such as providing new drawings every 90 days. The bankrupt licensor is not required to comply with such provisions, but if the licensor has those drawings sitting on a shelf as a type of inventory, the licensee has the right to compel delivery of the drawings.

There are some drawbacks to electing to retain a license. The licensee is deemed to have waived the right of set off, i.e., taking deductions from its royalty payment as a result of disputes with the licensor or to claim damages. This new provision has proved particularly appealing to a licensee contemplating signing a licensing agreement with a company which has attractive intellectual property, but not the best balance sheet in the world. The subsequent bankruptcy of the licensor is not necessarily the end of a license.

The Licensor's Rights

If it is the licensee who has requested reorganization under Chapter 11 or who has gone into bankruptcy under Chapter 7 the Reform Act provides that the trustee-in-bankruptcy has the right to forgive and discharge any royalties which the licensee owed to the licensor before the bankruptcy was filed and any monetary obligations of the licensee as a result of any infringement claims. The trustee is also entitled to transfer the license to the highest bidder, even one who may be a competitor of the licensor (provided that the licensee has decided not to go forward with the license agreement).

Noting this, any licensor would be rightfully quite concerned and would be looking at the standard bankruptcy provision in the license agreement for help. The standard clause typically provides that the license reverts back to the licensor. Unfortunately, this clause is not enforceable—the Bankruptcy Act gives the trustee the power to void the clause and to proceed as outlined above.

However, if the licensor had the foresight to enter into a security agreement with the licensee, the licensor would be elevated from an unsecured creditor (receiving nothing or a few cents on the dollar) to a *secured creditor* (who starts at the top of the list of those who partake in payment). It is important to note that any security arrangements, such as an installment payment plan or promissory notes, which are filed only with the United States Patent and Trademark office as a part of a patent or trademark assignment, do not qualify as establishing appropriate security interest in a patent or trademark. Such action would not change the status of the creditor to that of a secured creditor.

However, the licensor who obtained and properly filed an enforceable security interest in the intellectual property of the licensed product (limited to registered trademarks, copyrights and issued patents) is entitled to ask the bankruptcy court for an order prohibiting or placing conditions upon the trustee's use, sale or lease of the intellectual property. The trustee must ensure that the licensor's interests are adequately protected. For instance, if the "bankrupt" licensee's business continues through reorganization, but the licensee does not pay the royalties, the licensor's security agreement should permit it to foreclose on the intellectual property.

What if the customer files for bankruptcy?

It is not uncommon for the ultimate customer, for example, a department store, to file for bankruptcy. Either the licensor or the licensee can be confronted with a situation whereby product is shipped to a soon-to-be bankrupt entity. Here's a very good example of such a situation: Trucks loaded with the entire spring line of a particular licensed product set forth for the Rodlac department store chain distribution center on a Thursday. Rodlac declared its filing under Chapter 11 on Friday. When the goods left the shipper's loading dock, they were no longer the shipper's goods. The goods shipped belonged to the soon-to-be debtor, Rodlac. The only positive option available to the shipper was to be paid for the shipped goods. Under the Bankruptcy Code, certain rights of the seller are preserved. Broadly speaking, if state law gives the seller the right to recall goods en route to its customers, then the bankruptcy

law will permit recall as well. In the absence of such a statute, should a shipper reclaim goods in transit a bankruptcy trustee or a debtor-in-possession has the right to reverse this transaction, take in the goods and treat the seller as an unsecured creditor. We strongly suggest that you contact your attorney if any similar events are encountered.

The most important concept to remember here is that the declaration of Chapter 11 or of bankruptcy does not dissolve the inherent rights of any of the involved parties to continue to do business. Some knowledge, mixed with common sense regarding security interests and the establishment of rights, can go a long way toward avoiding a negative impact and allowing all concerned parties to continue doing business as usual.

Check our website at <http://www.grr.com> for additional information on intellectual property.

Be sure to visit our web site: <http://www.grr.com>. If you have any specific questions regarding intellectual property protection, address them to the Editor of *Tableware Today* magazine and we will answer them directly or through this column in the future. You may request a reprint of this article or any of the following articles: "Do It Yourself With Copyright", "Sell It and Protect It With Trademarks", "Unexpected Help From Design Patents"; "Trade Dress—a New Helping Hand for Product Protection", "Licensing Your Products", "Frequently Asked Questions About Intellectual Property Protection", "The U.S. Copyright Office: Update on Contact", "Protection From Copycats", "Starting Your Own Business—A Checklist", "The Retailer as Accomplice to the Sale of Knockoffs", "Navigating the Web—Legally", "Covenants Not to Compete: What You Should Know About Restrictions on Switching Jobs" and "The U.S. Copyright Office: Update on Contact", or our Primer, "What's a Copyright / Trademark / Patent?", by either calling (212) 684-3900, faxing your request to (212) 684-3999, or e-mailing your request to info@grr.com

Reprinted from:

February/March 1999
TABLEWARE
TODAY
THE TABLEWARE SOURCE