

ARE A LICENSEE'S RIGHTS TO INTELLECTUAL PROPERTY OF A BANKRUPT LICENSOR IN JEOPARDY?

*Precision Industries, Inc. v. Qualitech Steel SBQ, LLC, No. 01-2753 (7th Cir. April 23, 2003)**

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Section 365(n) of the Bankruptcy Code provides that where an intellectual property license is rejected as an executory contract of a bankrupt licensor, the licensee may nevertheless elect to retain its rights to the intellectual property (including a right to enforce any exclusivity provision) for the duration of the license term. Thus, a balance is struck between a debtor-licensor and its licensee: the licensee retains the right to exploit the intellectual property for the duration of the license it negotiated, while the rejection of the license relieves the debtor-licensor of other burdensome obligations it may have assumed under the license. However, the Seventh Circuit, in an important decision concerning real property lessees' rights to continued possession following rejection of the lease in bankruptcy, may have foreshadowed an alteration of that balance when a bankrupt debtor's technology is sold under §363 of the Bankruptcy Code.

Precision Industries, Inc. v. Qualitech Steel SBQ, LLC, No. 01-2753 (7th Cir. April 23, 2003) dealt with the interplay between sale orders issued under §363(f) and lessees' continuing rights in unexpired nonresidential leases under §365(h). However, the rationale of the decision to deny a lessee's possessory rights in property a trustee sells under §363(f) could be utilized in similar circumstances under §365(n) – particularly where legislative history states that the provision was modeled after §365(h). S. Rep. No. 100-305, at 4 (1988). In relevant part, §365(h)(1)(A)(ii) provides:

If the trustee rejects an unexpired lease of real property under which the debtor is the lessor and –

...

(ii) if the term of such lease has commenced, the lessee may retain its rights under such lease...

With noticeable similarity, §355(n)(1)(B) states:

If the trustee rejects an executory

contract under which the debtor is a licensor of a right to intellectual property, the licensee under such contract may elect—

...

(B) to retain its rights (including a right to enforce any exclusivity provision of such contract. . .) under such contract. . . .

Following the Seventh Circuit's rationale, the right to make such an election may not be available in certain bankruptcy sale contexts however.

Facts of the

Case.

In *Precision Industries*, the bankrupt debtor, Qualitech, had entered into a land lease and a supply agreement with Precision. The supply agreement provided that Precision would construct a supply warehouse at Qualitech's facility and operate it for a period of ten years. The lease granted Precision exclusive possession of the warehouse also for a period of ten years in exchange for nominal rent. At the end of the lease

The assumption that licensed rights will not be impaired in the event of the licensor's bankruptcy because the licensee may elect to retain its rights under §365(n) is no longer safely held.

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Qualitech had the right to purchase the warehouse for \$1, assuming no default. Qualitech filed for bankruptcy less than one month after executing the lease.

Approximately three months later, substantially all of Qualitech's assets were sold at auction. After a noticed hearing, the bankruptcy court entered an order approving the sale. Precision, with notice of the hearing, did not object to the order which provided that the assets were to be transferred "free and clear of all liens, claims, encumbrances, and interests" (other than those specified), pursuant to § 363(f). Anyone holding interests other than those specified in the order was barred from asserting those interests against the purchaser. The sale closed without assumption of either the lease or the supply agreement despite several extensions of negotiations toward that end, and, as a result, the lease and supply agreement were *de facto* rejected.

A few months later Precision completely vacated the warehouse. Shortly thereafter, the Qualitech purchaser, without Precision's knowledge or consent, hired a locksmith and changed the locks to the building. The purchaser's takeover of the warehouse led to the dispute ultimately considered by the Seventh Circuit. The bankruptcy court had found that the purchaser had acquired the warehouse from Qualitech free and clear of any rights of Precision. The district court reversed, ruling that the more specific provisions of §365(h) and Precision's possessory interest in

the warehouse survived the bankruptcy sale. According to the district court:

There is no statutory basis for allowing the debtor-lessor to terminate the lessee's possession by selling the property out from under the lessee, and thus limiting a lessee's post-rejection rights solely to cases where the debtor-lessor remains in possession of the property.

Analysis of the Seventh Circuit.

The Seventh Circuit disagreed. Instead the Court reasoned that Precision's possessory interest in the warehouse as a lessee constituted an "interest" under §363(f) of the Bankruptcy Code. Thus, the statute on its face authorized the sale of property of the bankruptcy estate free and clear of that interest.†

The Court concluded that the protections afforded by §365(h) did not supercede those of §363(f). The Court first noted that the statutory provisions themselves do not suggest that one supercedes the other. The Court then stated that the plain language of §365(h)(1)(A) suggests that it has a limited scope, focusing on the specific rejection of an executory contract by the trustee while failing to mention anything about sales of estate property. Therefore, the Court concluded that the statutory provisions apply to two distinct sets of circumstances. According to the Court, §365(h) applies only when the property is not sold and the debtor rejects the lease.

The Court also stressed that §363 provides "a mechanism to protect the rights of parties whose interests may be adversely affected by the

sale of estate property." In particular, §363(e) provides that "... on request of an entity that has an interest in property . . . proposed to be used, sold, or leased, by the trustee, the court . . . shall prohibit or condition such use, sale or lease as is necessary to provide adequate protection of such interest." The Court commented that:

"Adequate protection" does not necessarily guarantee a lessee's continued possession of the property, but it does demand, in the alternative, that the lessee be compensated for the value of its leasehold - typically from the proceeds of the sale.

Precision neither objected to the sale nor sought adequate protection, so the Court held its possessory interest was terminated.

Impact on Licensing Assumptions.

A commonly held assumption of intellectual property licensees is that their rights under a license will not be impaired in the event of the licensor's bankruptcy because the licensee may elect to retain its rights to use the intellectual property under §365(n).

Such an assumption is no longer safely held in the context of a prior sale of that intellectual property under §363(f). An analysis similar to the Seventh Circuit's in *Precision Industries* could also easily be made respecting the interplay between §365(n) and §363(f). As a result, licensees may need to be more proactive in objecting to sales of intellectual property in bankruptcy and in seeking adequate protection of their interests in connection with such sales.



† Perhaps significantly, Precision did not dispute whether any one of the conditions in §363(f) to a trustee selling such property free and clear of any interest was satisfied.