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Patent Licensee's Rights Are Perishable in Chapter 7 Bankruptcy

The U.S. Court of Appeals for the Fifth Circuit recently reminded bankruptcy trustees, creditors and asset buyers that patent licenses have a limited "shelf life" in Chapter 7 liquidations. When the Chapter 7 trustee did not assume the debtors' patent licenses within 60 days after the Chapter 7 case commenced (by conversion from Chapter 11), the licenses were deemed rejected and could not thereafter be assumed or sold.

The fact that the debtors had not disclosed the patent licenses by listing them on the requisite bankruptcy schedules did not provide any protection for the Chapter 7 trustee or the company that believed it bought all of the debtors' assets. The licenses had been rejected and could not be brought back to life or assigned to a buyer. More details regarding *In re Provider Meds, LLC*, (5th Cir. No. 17-11113, October 29, 2018) are provided below.

Background

Tech Pharmacy Services (Tech Pharm) entered into a Settlement, Release and License Agreement (the License Agreement) to license certain patents to settle pre-bankruptcy litigation with the debtors. The license agreement governed the use of Tech Pharm's allegedly patented technology in the debtors' remote pharmaceutical dispensing machines in long-term care facilities. The debtors' subsequent Chapter 11 bankruptcy cases were eventually converted to Chapter 7 liquidations. Each debtor failed to list the License Agreement on its bankruptcy schedules.

Well beyond 60 days after the conversion to Chapter 7, the debtors' lender purchased substantially all of the assets of three of the debtors. Each of the bankruptcy court's sale orders stated that to the extent any of the acquired property was an executory contract, such contract was "hereby ASSUMED by the Estate and immediately ASSIGNED to [lender] under the applicable provisions of section 365 of the Bankruptcy Code."

Tech Pharm eventually filed suit in state court against several companies, including the debtors, asserting infringement of its patents. The lender/buyer intervened and sought to enforce its rights under the sale orders by removing the lawsuit to the bankruptcy court. The bankruptcy court ruled that the License Agreement was a rejected executory contract which could not have been assigned to the lender/buyer notwithstanding the finality of the bankruptcy court orders approving the sales and including the executory contract language. The district court affirmed, and the issue then went to the Fifth Circuit.

Fifth Circuit Decision

The Fifth Circuit agreed with the lower courts and ruled that the License Agreement had been rejected by operation of law before the sale orders were entered. The 60-day period began when each case converted to Chapter 7 and ended before the sale. The lender/buyer argued for an implicit exception into Bankruptcy Code Section 365(d)(1) when the debtor fails to schedule an executory contract and the trustee is unaware of its existence within the 60-day period. The Fifth Circuit joined the courts below in refusing to do so, finding that the Bankruptcy Code places an affirmative duty on the trustee to "investigate the financial affairs of the debtor." While some courts have provided relief from the 60-day period for intentionally concealed contracts, that issue was not presented in this case.

Takeaways

Understanding the difference between the way executory contracts are treated in Chapter 7 liquidations and their treatment in Chapter 11 reorganization cases is critical. Executory contracts may generally be assumed or assumed then assigned at any point before a plan of reorganization is confirmed in a Chapter 11 case. While this provides relief from the strict 60-day time frame, a contract counterparty should consider monitoring the bankruptcy court's docket on a regular basis to determine whether a rejection request has been filed since any assumption or assumption and assignment of the contract must precede a rejection of the contract.

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