



Trademark Licensing

Stephen Reily

The Bankruptcy Clause: What to Put in Its Place

In my last column I wrote about the "bankruptcy clause," which generally provides for immediate termination of a license agreement if the licensee files for bankruptcy. No licensor wants a bankrupt licensee, and the bankruptcy clause seems like a rational way to protect against that risk. Unfortunately, federal law makes the bankruptcy clause unenforceable. Licensors should take no comfort in a clause that they cannot use, and IP lawyers are doing no client a favor by including the clause in their form agreements; the bankruptcy clause should be erased.

The licensor's underlying concern, that of the licensee's financial ability to perform, does remain valid and needs to be addressed. The bankruptcy clause is simply not an appropriate way to address it. There are several different ways to protect a licensor from its licensee's insolvency, all of which will give licensors tools they can use, unlike the bankruptcy clause, before it is too late.

Some of those tools are clauses that many license agreements already include; licensors must use them proactively to protect themselves against any licensee's deteriorating financial condition. Others are clauses that should be included in license agreements—clauses that would serve licensors better than the useless bankruptcy clause.

Using Existing Clauses Better

The best evidence of a licensee's ongoing financial stability is its ongoing and timely payment of royalties. Because almost all license

agreements require the payment of royalties on a regular schedule, they already contain a useful tool for overseeing each licensee's solvency. Licensors should be vigilant in using royalty payment provisions to police licensee solvency, and should not hesitate to use termination provisions if a pattern of late payments suggests a licensee is nearing bankruptcy.

Licensors are sometimes more afraid of terminating agreements than they should be. Termination is unpleasant but does not have to end the licensor's relationship with a licensee whose financials are wobbly. The license agreement could simply be converted into a month-to-month (or quarter-to-quarter) arrangement, granting the licensee no rights beyond a limited time frame, and sparing the licensor from the risk that its multi-year obligation might end up stuck and out of reach in bankruptcy court.

Adding New Protections to License Agreements

A licensor makes a loan of its most valuable asset—its brand—to each licensee, and licensors should take a lesson in financial risk management from the world's other big lenders: banks.

Banks control the risks of bad loans by including financial covenants in their loan agreements. They use these covenants as ways to monitor a borrower's financial status, and call their loans before the borrower gets too close to bankruptcy. Licensors can reduce their own exposure to financial risk by including similar provisions in their license agreements.

Adding such provisions will not make the licensor's job as difficult

as a bank's. Financial covenants need not be complicated, or require an unusual amount of oversight. Any licensor can use Dun & Bradstreet as the judge of its licensee's financial strength. A license agreement can provide that the agreement shall terminate if the licensee's D&B rating falls below a certain level, or if its payables as reported by D&B extend beyond a certain time period. Of course, licensors can build in more complicated covenants—they could require that the licensee's balance sheet reflect a "current ratio" greater than 2:1, or require that the stated value of the licensee's assets exceed the value of its liabilities. The goal is not to end up overseeing every detail of the licensee's financials; the goal is only to know enough about the licensee's financial status to avoid joining it on its way into bankruptcy court.

For licensors to enforce financial covenants, their licensees will have to provide them with quarterly or annual financial statements. License agreements should include this requirement even if they do not include specific financial covenants. Licensors can never know too much about their licensee's financials.

Many licensors think that the bankruptcy clause they include in their form agreement will prevent them from ending up fighting to take back their brand from a bankruptcy trustee. They are wrong. The best way to avoid the risk of a licensee's bankruptcy is to know as much as possible about a licensee's finances, and to rely on clauses that (unlike the bankruptcy clause) actually *can* be enforced, to ensure that its licensees are the ones it chooses.

Stephen Reily is president and CEO of IMC Licensing in Louisville, KY. IMC Licensing is a licensing agency that represents brands with the potential to earn royalties from licensing forever.