

The Kodak Bankruptcy

The Valuation and Sale of IP Assets

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On Jan. 18, 2012, Eastman Kodak Company and 15 of its affiliates (collectively, Kodak) filed voluntary Chapter 11 petitions in the Bankruptcy Court for the Southern District of New York. Case No. 1:12-bk-10202-alg. Kodak, which describes itself as "one of the world's leading material science companies," has worked to transform its business from one primarily based on film and consumer photography to one with a "digital growth strategy focused on the commercialization of proprietary digital imaging and printing technologies." The costs associated with this transformation are one of the reasons Kodak commenced its bankruptcy case.

Kodak has developed significant intellectual property over the years, and currently owns 13,100 foreign patent and trademark registrations or pending registrations in approximately 160 countries and 9,800 patent and trademark registrations and applications in the United States. These patents

include Kodak's digital capture and imaging portfolio, which historically has generated significant revenue for Kodak, earning \$3 billion in licensing revenue from 2003 through 2010. However, in 2011, licensing revenues from the digital capture and licensing portfolio declined to \$98 million. The sale of this and other intellectual property figures prominently into Kodak's plans for reorganization.

KODAK BEGINS THE SALE PROCESS

The most significant intellectual property Kodak seeks to sell through its bankruptcy case is its digital capture and imaging patent portfolio, which contains approximately 1,150 patents with related foreign and pending applications. Kodak attempted to sell these patents before commencing its bankruptcy case, and has valued the patent portfolio at between \$2.2 and \$2.6 billion. At press time, Kodak had not yet announced whether it will sell the digital capture patents as a portfolio or if it will sell the patents individually, and it is not required to file a motion for approval of bidding procedures until June 30, 2012.

Kodak has also taken steps to divest less significant assets. On Feb. 28, 2012, the court entered an order approving expedited procedures for the sale or abandonment of assets worth less than \$10 million. Although these procedures do not require Kodak to seek court approval of sales of these *de minimis* assets under section 363 of the Bankruptcy Code, they do require Kodak to provide notice of the sale of any intellectual property to those parties who

requested notice of the transfer, including Apple, Fujifilm and Samsung. The order further provides that Kodak must provide notice of the sale to any counterparties to executory contracts (such as a licensee of intellectual property) if Kodak will assume and assign or reject an executory contract as part of the sale.

On March 2, 2012, Kodak filed a motion for approval of bidding procedures for the sale of its Kodak Gallery online photo services business, and authorization to enter into a stalking horse purchase agreement with Shutterfly in connection with that sale. Shutterfly has submitted a bid of \$23.8 million for Kodak Gallery, and Kodak will seek higher bids through a section 363 auction. The sale of the Kodak Gallery business does not involve the transfer of any intellectual property.

RIGHTS OF IP

LICENSEES IN A SALE

Because Kodak is in the business of licensing intellectual property, much of the intellectual property it seeks to sell will be licensed by third parties. Although section 365(a) permits a debtor to assume or reject any executory contract (including a license of intellectual property, *see In re Select-A-Seat Corp.*, 625 F.2d 290 (9th Cir. 1980); *In re Catapult Entertainment, Inc.*, 165 F.3d 727, 750 (9th Cir. 1999)), a debtor's rejection rights are limited by section 365(n).

Recognizing the growing importance of intellectual property to American businesses, Congress enacted section 365(n) to protect licensees of intellectual property. Prior to the enactment of section 365(n), if

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a debtor-licensor rejected a license, the licensee would only have a claim for money damages.

Section 365(n) gives a licensee a choice upon rejection of an IP license: The licensee can elect to treat the license as terminated, giving the licensee a pre-petition breach of contract claim, or the licensee can retain its existing rights under the license for the term of the license and any extension that the licensee may exercise as of right. If the licensee elects to retain its rights, it must continue to make all royalty payments and waive any rights of set off and any administrative expense claim relating to the rejection of the license. Upon a licensee's election to retain its rights, the debtor must provide the licensee with any prepetition intellectual property held by the debtor and refrain from interfering with the licensee's rights to use the intellectual property, including any right to obtain intellectual property from the debtor or a third party.

There are several important limitations on the protections afforded by section 365(n). First, courts have held that, because of the specific manner in which intellectual property is defined under the Bankruptcy Code, section 365(n) does not apply to trademarks. However, a licensee of both trademarks and other intellectual property rights may circumvent this limitation by objecting to the rejection of the trademark on the basis that the trademark is integrally related to its other intellectual property rights. *Raima UK Limited v. Centura Software Corp.* (*In re Centura Software Corp.*), 281 B.R. 660, 672 (Bankr. N.D. Cal. 2002). The second limitation of section 365(n) is that it only gives the licensee the right to retain the intellectual property on the condition that it existed on the petition date, *i.e.*, the licensee has no right to any updates. Third, the licensee cannot enforce any other terms of its licensing agreement with the debtor, such as an agreement for the debtor to provide technical support services.

A common concern of licensees is whether a debtor's sale of the relevant intellectual property under section 363 of the Bankruptcy Code can be made free

and clear of any rights of the licensee under 365(n). As a practical matter, licensees should always attempt to obtain a ruling of the court under section 365(n) prior to, or simultaneously with, any sale by the debtor of the underlying intellectual property. Once such a ruling is made, it should be clear whether the intellectual property is subject to, or free of, the license rights. Failure to follow this practice may create significant uncertainty because the extent to which the protections of section 365(n) apply after a sale free and clear has not been addressed by any court. Given that section 365(n) is a right provided to licensees of intellectual property in which the debtor has an interest, it is debatable whether section 365(n) would have any applicability to the intellectual property in the hands of the buyer post-sale. Moreover, as a practical matter, one of the benefits of seeking a ruling under 365(n) pre-sale is that such a request frequently results in a negotiated resolution of the rights of the licensee post-sale.

Despite the dearth of case law concerning the effect of section 365(n) on section 363, courts have considered the interplay of section 365(h), a provision of the Code designed to protect the rights of lessees that is analogous to section 365(n), and section 363(f), which authorizes sales free and clear of interests, liens and encumbrances, provided that certain requirements are met. In *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC*, 327 F. 3d 537 (7th Cir. 2003), the Seventh Circuit held that section 365(h) did not bar a sale free and clear of the lessee's interests. In reaching this decision, the court noted that section 365(h) applied to rejection of contracts and did not speak to the sale of estate property, and that section 363 provided a mechanism to protect the rights of parties whose interests were adversely affected by a sale. 327 F. 3d 537, 547-548. This reading — that section 365(h) only applies in the absence of a sale — allowed the court to construe the two provisions of the Code in order to give effect to both. *Id.* at 548. Other courts have held that sale orders can be crafted to protect a licensee's rights under section 365(n). See *In re Dy-*

namic Tooling Sys., Inc., 349 B.R. 847 (“In short, while some case law suggests that estate property may be sold free and clear of licensee interests, the Court can ameliorate what little harm such sale would work here by ordering that the transfer [] be subject to whatever licensee rights [exist] in [the] intellectual property.”); *but see In re Cellnet Data Sys., Inc.*, 327 F. 3d 242, 249 n.2 (3d Cir. 2003) (noting that sale order authorizing sale free and clear was modified to account for licensee's rights under section 365(n)).

Some district courts have disagreed with the holding of *Precision Industries* and have relied on other principles of statutory interpretation to hold that the more specific provisions of section 365(h) prevail over the general provisions of section 363(f). See, *e.g.*, *In re Churchill Prop. III, L.P.*, 197 B.R. 283 (Bankr. N.D. Ill. 1996). These courts have reasoned that allowing section 363(f) to override section 365(h) would deprive lessees of the protections Congress specifically bestowed on them through section 365(h). *Id.*

In light of the unsettled state of the law regarding the effect of section 365(n) on sales free and clear, any entity interested in purchasing intellectual property from Kodak will need to consider whether it is willing to purchase the property even if it must continue to license the intellectual property to the current licensees after the sale. In addition, prospective purchasers should inform themselves of all licenses of the intellectual property, and should also determine whether there are competing ownership claims.

COMPETING OWNERSHIP CLAIMS MAY COMPLICATE A SALE

The sale of Kodak's intellectual property, especially the digital capture and imaging patent portfolio, will be complicated by the competing ownership claims asserted with respect to certain patents. Even before filing for bankruptcy, Kodak was heavily involved in patent infringement litigation, including lawsuits against Apple Inc., HTC Corp., Samsung, Research In Motion, Shutterfly and Fujifilm Corp. Many of these companies have been active participants in Kodak's bankruptcy case in

order to protect and advance their interests in their patent litigation with Kodak. The litigation between Kodak and Apple is of particular interest because Apple asserts that it is the owner of Kodak's patent entitled "Electronic Camera for Initiating Capture of Still Images While Previewing Motion Images," U.S. Patent No. 6,292,218. The '218 patent is likely one of the patents Kodak will sell as part of its digital capture patent portfolio.

Kodak asserts that Apple infringes on the '218 patent with the iPhone and the iPad, and claims that Apple's failure to pay royalties for the '218 patent was one of the reasons it had to file bankruptcy. Pre-petition, Kodak asked the International Trade Commission (ITC) to investigate whether the iPhone infringes on the '218 patent and filed a companion action in the Western District of New York. *In re Certain Mobile Tels. & Wireless Comm'n Devices Featuring Digital Cameras, & Components Thereof*, Inv. No. 337-TA-703; *Eastman Kodak Co. v. Apple Inc.*, Civil Action No. 6:10-cv-06021-MAT. The Western District of New York action is stayed by the ITC proceeding. In January 2012, Kodak asked the ITC to investigate whether Apple infringed on four patents that allowed users of digital cameras to share images without first downloading them. Apple denies Kodak's claims and asserts that Kodak stole the technology in the '218 patent from Apple.

From the beginning of Kodak's bankruptcy case, Apple has been an active participant. Along with other companies against whom Kodak has asserted patent infringement claims, Apple objected to Kodak's proposed debtor in possession financing to the extent that the DIP financing motion sought to grant security interests in and liens on patents owned by Apple. Subsequently, Apple filed a motion requesting permission to file complaints against Kodak with the ITC and in federal court with respect to Kodak's alleged post-petition infringement of patents related to printers, digital cameras, digital video cameras and digital picture frames. Apple also filed a motion for relief from stay to allow the litigation in the Western District of New York relating to the ownership of

the '218 patent to proceed. The court denied Apple's motion for authorization to file an ITC complaint in order to allow Kodak to take advantage of the breathing spell provided by the automatic stay after finding that Apple could have filed the complaint before Kodak commenced its bankruptcy case. The court also denied Apple's request to proceed with litigation in district court. At the hearing on the motions for relief from stay, the court addressed the issue of ownership of the '218 patent, stating "It is not at all certain at this stage of the [C]hapter 11 cases what determination must be made as to the debtor's property rights before such property can be sold under section 363." Kodak has sought to examine Apple pursuant to Federal Rule of Bankruptcy Procedure 2004 regarding Apple's repeated claims of ownership in the '218 patent.

Kodak believes that the parties seeking relief from stay are doing so in order to interfere with its reorganization process and the sale of the patents. However, there are valid reasons for allowing the patent litigation to proceed because any entities claiming ownership of the intellectual property that Kodak seeks to sell are likely to oppose any sale, potentially delaying the sale until the patent litigation has been resolved. Moreover, to the extent there is a cloud over the ownership of Kodak's intellectual property, it may depress the sale price.

VALUATION OF KODAK'S INTELLECTUAL PROPERTY

As noted above, Kodak believes the digital capture patent portfolio is worth between \$2.2 and \$2.6 billion. A potential purchaser of the digital capture patent portfolio, or any of Kodak's other intellectual property, must select one of the myriad methods for valuing intellectual property to determine its bid. The three most common methods are the cost method, the income method, and the market method.

Robert F. Reilly, *Valuation of Debtor Corporation Intellectual Property in a Distressed Economy (Part I)*, 18 *Am. Bankr. Inst. J.* 56, 57 (June 2009). The cost method calculates the value of the intellectual property based on the historical cost of development or on the replacement cost. The income method calculates the value of intellectual property based on the future stream of income from the asset. One variant of the income method is the relief-from-royalty approach, which calculates the value of the asset as the present value of the royalties the purchaser is relieved from paying as a result of purchasing the asset. This method is unlikely to provide an accurate valuation in the case of a patent licensed to more than one entity because that entity would derive additional value from being able to prevent its competitors' use of the patent. The market method compares other transactions involving similar intellectual property.

CONCLUSION

The sale of Kodak's intellectual property will almost certainly occur through an auction since a section 363 sale is designed to maximize the proceeds received by the estate. In order to avoid low-ball offers, such sales generally are subject to an offer by a stalking horse bidder, whose bid is selected by the debtor prior to the auction as the opening offer. Subsequent bidders are generally required to overbid by a set amount. Due to the complicated legal and factual issues to be analyzed in connection with any purchase of intellectual property from Kodak, potential acquirers of Kodak's intellectual property should engage patent counsel with experience in IP valuation and representing buyers in section 363 sales.

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