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Where Bankruptcy Law and Intellectual Property Law Intersect

The intersection of bankruptcy law and intellectual property law is not a very nice neighborhood. Anyone dealing with intellectual property license agreements must think about how these agreements are affected if one party to the agreement becomes insolvent. Below are strategies to help parties draft license agreements that will pass through this intersection relatively safely.

Bankruptcy Concepts

Bankruptcy Code Section 101(35A) defines trade secrets, patents and patent applications, copyrights, and mask works as intellectual property. It is important to note that trademarks do not fall within the definition of intellectual property under Section 101(35A). An executory contract, a bankruptcy law term of art, is a contract whereby the parties' obligations are so underperformed that the failure of one party to complete performance would be considered a material breach, thus excusing performance by the other party.

Bankruptcy Code Section 365(a) allows a trustee to reject executory contracts subject to a business judgment standard that is relatively easy to satisfy. Rejection of an executory contract by the debtor is considered a breach, which gives rise to an unsecured claim; the unsecured claim may garner pennies on the dollar.

Most intellectual property license agreements are considered an executory contract because there are ongoing obligations to all parties to the agreement. However, this is not a forgone conclusion. For example, an intellectual property agreement whereby the licensee is required to pay a prepaid fee may not be considered an executory contract.

Licensor is Debtor

If the debtor is the licensor who rejects the license agreement, Bankruptcy Code Section 365(a) allows the licensee to: (1) treat the debtor-licensor's rejection of the license agreement as a termination; or (2) retain its rights under both the license and supplemental agreements for the duration of the agreement as well as any renewal periods. If the licensee chooses the former, calculating damages caused by the termination becomes much more difficult, and the licensee is relegated to standing in line with all other unsecured debt holders when attempting to secure payment. Additionally, this option leaves the licensee without the intellectual property it may have built its underlying business upon.

If the licensee chooses the latter option, the debtor-licensor must allow the licensee to continue using the licensor's intellectual property without interference in exchange for the licensee's continued royalty payment made to the licensor. The licensee waives all rights to claims it has or may have against the debtor-licensor, other than claims for unsecured debt. The licensee may petition the debtor-licensor, in writing, to hand over to the licensee any intellectual property, or embodiment thereof, to which the licensee is entitled under the

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license agreement. The debtor-licensor is relieved of any affirmative obligations under the license agreement, such as paying patent maintenance fees.

Licensees should take time to plan for the possibility that the licensor becomes insolvent during the course of their relationship. Intelligent planning could lead to a licensee's acquisition of proprietary rights associated with intellectual property in the post-bankruptcy stage. As part of this planning, the licensee should negotiate an escrow agreement for the transfer of intellectual property to an escrow agent.

The escrow agreement should be structured as two agreements: the first between the licensor and the escrow agent, and the second between the licensee and the escrow agent. This structure obligates the licensor to transfer licensed intellectual property to the escrow agent upon breach of the license agreement. Further, the escrow agent is permitted to release the licensed intellectual property to the licensee upon notice of the licensor's breach.

Under the Bankruptcy Code, escrow agreements are considered enforceable supplementary agreements. Drafters should carefully note that license agreements must be considered executory for this approach to be successful. Consequently, drafters should specifically call out ongoing obligations of each party to the license while also pointing out that failure to perform any of the ongoing obligations constitutes a material breach.

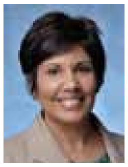
Licensee is Debtor

As discussed above, Section 365(a) allows a trustee to accept or reject a burdensome executory contract. The trustee can accept an executory contract if it cures, or provides assurance that it will cure, all outstanding monetary defaults. Bankruptcy Code Section 365(f) allows the debtor to assign an agreement to a third party as long as that third party provides adequate assurance of performance under the agreement, notwithstanding any provision in the agreement or applicable law prohibiting assignment. Bankruptcy Code Section 365(c) does not allow a debtor to assume or assign an executory contract if: (1) the applicable law excuses the non-debtor from accepting performance from, or rendering performance to, the potential assignee; and (2) the non-debtor withholds consent to assign. More simply, under certain circumstances a debtor-licensee may be able to accept an intellectual property license agreement and assign it to another entity against the licensor's wishes.

Many courts have found that the licensee of an exclusive license is entitled to all rights of the licensor, including transfer rights, such that the licensee effectively has an ownership interest in the intellectual property, the assignment of which cannot, or should not, be restricted. Thus, a licensee with an exclusive license agreement can assign that agreement in bankruptcy if it satisfies the requirements of Section 365. Many courts have found that non-exclusive licenses are personal to the licensee and do not give rise to a property interest. Therefore, non-exclusive licenses are not assignable over the licensor's objection.

Some courts have held that if an executory contract cannot be assigned, it likewise cannot be assumed. Whether the licensee was actually seeking to assign the agreement is irrelevant. A number of courts take this a step further and hold that if the agreement cannot be assumed then it must be rejected or terminated. Thus, a licensee that files for Chapter 11 to protect its assets may, in the wrong jurisdiction and under the wrong circumstances, suddenly find itself deprived of a valuable license agreement. Courts have employed creative analyses to prevent such a harsh result. For example, some courts have adopted the "ride through" doctrine, under which a debtor can retain the benefits of an agreement not by assuming or rejecting it in bankruptcy, but rather by allowing it to "ride through" the case.

In conclusion, a licensor will want to keep the exclusive/non-exclusive distinction in mind if negotiating a license agreement with a financially distressed licensee. Moreover, one could argue that non-exclusive licenses may be assignable by a debtor-licensee in bankruptcy if the license agreement provides that consent to assignment may not unreasonably be withheld. Thus, licensors should think twice before incorporating such language. Since the Bankruptcy Code requires that "adequate assurances" be provided before the debtor licensee can assign an executory contract, the licensor should define what constitutes "adequate assurances." The licensor may also want to consider an accelerated fees provision. In the event that a debtor-licensee elects to reject the license, early liquidated fees or liquidated damage provisions accelerating payment of future royalties upon termination may increase the licensor's potential monetary recoupment if they are deemed a creditor.



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