

*Sills Cummis Epstein & Gross P.C. Life Sciences and Health Care Series*

## What Every Licensee Of Life Sciences Intellectual Property Should Know About Licensor's Bankruptcy – Part II *Alternative Transaction Strategies to Minimize Bankruptcy Impact*

**Boris I. Mankovetskiy**

**SILLS CUMMIS EPSTEIN & GROSS  
P.C.**

Although section 365(n) of the Bankruptcy Code provides a licensee certain protections if the license agreement is rejected, which we discussed in Part I last month, these protections do not completely preserve the licensee's pre-bankruptcy rights. For example, if the debtor/licensor rejects the license agreement, it no longer is obligated to perform any research and development services with respect to the intellectual property covered in the license. Rather, the debtor/licensor may be able to undertake such research and development efforts post-bankruptcy for its own benefit and license the enhanced product to third parties. Similarly, if the intellectual property is licensed as part of a servicing, market-

*Boris Mankovetskiy is an Associate in the Firm's Creditors' Rights/Bankruptcy Reorganization Practice Group. The views and opinions expressed in this article are those of the author and do not necessarily reflect those of Sills Cummis Epstein & Gross P.C. This is the second in a series of articles focusing on the Life Sciences and Health Care Industry.*



**Boris I. Mankovetskiy**

ing or manufacturing transaction, a bankruptcy court may find the licensing aspects of the contract not to be the primary purpose of the transaction and characterize the overall contract as something other than an intellectual property license. In that case, the licensee will not be able to obtain the protections of section 365(n). Consequently, it behooves a licensor to consider transaction strategies that will help to avoid or minimize the impact of the licensor's bankruptcy on the licensee's rights to the intellectual property. These strategies consist of

structuring the transaction to prevent the intellectual property and any related agreements from becoming property of the debtor/licensor's estate under section 541 of the Bankruptcy Code or structuring the transaction to include disincentives for the debtor/licensor to reject the license under section 365 of the Bankruptcy Code.

### **Excluding Intellectual Property From Bankruptcy Estate Absolute Assignment**

Property sold or absolutely assigned by a debtor prior to the bankruptcy filing does not constitute property of the debtor's estate because such a sale or an assignment divests a debtor of all interests in the sold or assigned property. Accordingly, the best way to avoid the problems associated with the rejection of an intellectual property license is to structure a transaction that will accomplish a complete transfer of the original owner's title to the intellectual property pre-bankruptcy. Once the closing of the sale takes place, the previous owner will have no material unperformed obligations and there will be no possibility of a rejection of an executory contract. Of course, the original owner may not be interested in transferring title to what may be its most valuable asset. In some instances, this obstacle may be overcome by structuring

*Please email the author at [bmankovetskiy@sillscummis.com](mailto:bmankovetskiy@sillscummis.com) with questions about this article.*

the transaction as a sale-license back. Thus, the original owner can sell or absolutely assign the intellectual property to the other party who will immediately license back to the original owner the right to use the intellectual property. This structure allows both sides to use the intellectual property while divesting the original owner of title to the property and avoiding rejection problems under the Bankruptcy Code.

---

---

“Another mechanism through which a licensee can keep intellectual property out of the owner’s potential bankruptcy estate is to have the owner transfer title to the intellectual property to a new corporation or limited liability company...”

---

---

#### **Intellectual Property Trusts**

If the owner of the intellectual property is not willing to enter into a sale or absolute assignment, the intellectual property owner may agree to transfer the ownership of the intellectual property to a trust. The trust would in turn license the intellectual property to the licensee. The trustee would possess legal title to the intellectual property and the original owner would have a continuing beneficial interest in the intellectual property, including the proceeds of any license agreement. While the beneficial interest would still be considered property of the owner’s bankruptcy estate, this transaction would remove the intellectual property itself from the bankruptcy estate. This will prevent the debtor’s rejection of the license agreement because the debtor is not a party to the agreement – the license agreement is between the trustee and the licensee.

#### **Bankruptcy Remote Entities**

Another mechanism through which a licensee can keep intellectual property out of the owner’s potential bankruptcy estate is to have the owner transfer title to the intellectual property to a new corporation or limited liability company established solely for the purpose of owning the intellectual property and licensing it

to others which would have all the features of a bankruptcy-remote entity. The articles of incorporation and by-laws of this corporation should (i) limit the corporation’s authority to engage in any business other than licensing the intellectual property; (ii) give the corporation no authority to incur debt or otherwise encumber its assets; and (iii) prevent the corporation from filing a voluntary petition for bankruptcy. Specific mechanisms should also be included to limit the corporation’s ability to amend its articles of incorporation or by-laws. The corporation should have different classes of stock so that the licensee can have some control over its corporate governance, while allowing the original owner of the intellectual property to receive the economic benefits of such property. Most importantly, the bankruptcy-remote entity must maintain its organizational separateness from the original owner of the intellectual property. Otherwise, the bankruptcy-remote entity may be substantively consolidated with the original owner in a bankruptcy case of the original owner.

---

---

“If the owner of the intellectual property is not willing to enter into a sale or absolute assignment, the intellectual property owner may agree to transfer the ownership of the intellectual property to a trust.”

---

---

#### **Creating Disincentives To Rejection And Increasing Licensee’s Leverage In Bankruptcy**

If the owner of the intellectual property is unwilling to structure a transaction of the type discussed above, the licensee should require a security agreement in conjunction with the license transaction. The security agreement should provide that, to secure the licensor’s performance of the license agreement, the licensor grants to the licensee a security interest in the licensed intellectual property. Although the security agreement does not prevent a potential rejection of a license agreement, it effectively converts what would otherwise be a general unsecured

claim for rejection damages to a secured claim upon the rejection of a license agreement. This may create an economic disincentive for the debtor/licensor to reject the license agreement.

In addition, secured status may enable the licensee to exert pressure upon the debtor/licensor by threatening to move for relief from the automatic stay of section 362 of the Bankruptcy Code or by requesting adequate protection for the debtor/licensor’s use of the collateral (e.g., the cash proceeds resulting from the licensing of the intellectual property constituting the collateral to third parties) pursuant to the provisions of section 363 of the Bankruptcy Code.

---

---

“The security agreement should provide that, to secure the licensor’s performance of the license agreement, the licensor grants to the licensee a security interest in the licensed intellectual property.”

---

---

#### **Conclusion**

Licensing life sciences intellectual property and technology from a financially troubled or start-up company is inevitably risky. While the Bankruptcy Code provides certain protections to the licensee in the event of the debtor/licensor’s rejection of the license agreement, these protections do not allow the licensor to retain all benefits of its pre-bankruptcy bargain. Nevertheless, an entity seeking to obtain intellectual property from a financially troubled or start-up company may reduce the risks posed by a potential bankruptcy by structuring the transaction in a way that will either remove the intellectual property from the bankruptcy estate or create disincentives for the rejection of the license agreement. Although some degree of risk will always be present in doing business with a financially troubled or start-up company, by knowing its rights under the Bankruptcy Code, and through careful pre-bankruptcy planning, the counterparty to the transaction can significantly minimize the disruptive effects on its business of the licensor’s bankruptcy.