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What Every Licensee Of Life Sciences Intellectual Property Should Know About Licensor's Bankruptcy – Part I

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When an entity wishing to obtain rights to life sciences intellectual property enters into a licensing agreement, it expects to receive the full benefits of the bargain throughout the term of the license. Unfortunately, in many instances, the intervening bankruptcy of the licensor can dramatically change the parameters of the deal and undermine the licensee's expectations. The need for protection is particularly acute when an entity desires to license intellectual property owned by a financially troubled or start-up company in the life sciences arena, which often lacks sufficient capital prior to the commercialization of its products. Proper pre-bankruptcy planning can help licensees of life sciences intellectual property reduce the risks posed by the licensor's potential bankruptcy.

Under the Bankruptcy Code, the debtor/licensor may reject an executory contract and relieve itself of all obligations arising under such contract. Intellectual property licenses are typically deemed to be executory contracts under the Bankruptcy Code. The Bankruptcy Code provides limited protections to the licensee upon the rejection of the intellectual property license, which will be explored in this Part I. Next month, in Part II, we will discuss alternative strategies which the licensee should consider pre-bankruptcy, during the negotiation and structuring of the transaction, to minimize the risks posed by the licensor's bankruptcy. Although none of these options is a perfect solution, pre-bankruptcy planning may minimize the risk of loss and improve the non-debtor's bargaining position if the owner of the intellectual property and technology ultimately files for bankruptcy.

Protections Under the Bankruptcy Code

Through section 365(n) of the Bankruptcy Code, Congress granted to a non-debtor licensee certain special protections because of the detrimental impact that a rejection of an intellectual property license can have on the licensee's business. The Bankruptcy Code defines intellectual property as: (i) a trade secret; (ii) an invention, process, design, or plant protected under title 35 of the U.S. Code; (iii) a patent application; (iv) a plant variety; (v) a work of authorship protected under title 17 of the U.S. Code; or (vi) a mask work protected under chapter 9 of title 17 of the U.S. Code. It should be noted that this definition of intellectual property does not include trademarks.

Pre-Rejection Period

Although a debtor typically is not required to perform its obligations under an executory contract pending its decision to assume or reject the contract, section 365(n)(4) gives a licensee the right to request that the trustee or debtor in possession continue to perform under an intellectual property license. Once a licensee makes such a request in writing, the trustee or debtor in possession must, to the extent provided in the license or supplementary agreement, either (i) continue to perform its obligations under the license or (ii) turn over to the licensee the licensed property, including any embodiment thereof. Additionally, the trustee or

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debtor in possession may not interfere with the rights of the licensee under the intellectual property license or any supplementary agreement.

Post-Rejection Options

If a debtor/licensor chooses to reject an intellectual property license, the licensee may either (i) treat the intellectual property license as terminated (if the rejection of the license agreement constitutes a breach that would entitle the licensee to terminate the agreement under the terms of the agreement, applicable nonbankruptcy law or an agreement between the licensee and another entity) or (ii) retain its rights under the license for the initial term of the license and any lawful extensions thereof.

Treating the License as Terminated

The licensee may treat the license as terminated, cease performing its obligations under the license, and file a general unsecured claim against the debtor/licensor's bankruptcy estate for damages arising from the debtor/licensor's breach of the license agreement. This option will typically prove inadequate to the licensee because it is difficult to measure the monetary damages caused by a debtor/licensor's rejection of the license agreement and, even if the licensee can estimate the damages caused by the rejection, a distribution on an unsecured claim does not give the licensee what it bargained for – the use of the licensed intellectual property in the operation of its business.

Retaining Use of the License

Section 365(n)(1)(B) allows a licensee to retain the rights held by the licensee under the license or any supplementary agreement at the time of the bankruptcy petition. If the licensee had an exclusive right to use the intellectual property as of the bankruptcy petition date, the trustee or debtor in possession may not take any action that abridges that right. However, section 365(n)(1)(B) specifically excludes the licensee's right to obtain any future performance under the license other than the enforcement of the exclusivity clause. In addition, because the licensee only retains those rights that existed as of the petition date, if the debtor/licensor improves the licensed intellectual property post-petition, the licensee has no rights in such improvements even if it had negotiated them in the license agreement. Thus, potentially, a debtor/licensor may develop an advanced version of the licensed intellectual property post-petition and license this property to a third party notwithstanding the exclusivity provision in the rejected license.

If a licensee elects to retain its rights under the license agreement, the licensee must continue to pay to the trustee or debtor in possession all royalties due under the license for the initial term of the license and any lawful extensions thereof. For this requirement to apply, a payment need not be labeled as a "royalty payment" in the license agreement. Some courts have interpreted the term "royalties" broadly to include any fee or payment due from the licensee under the license agreement, including the initial licensing fee.

In addition to paying for the use of the intellectual property under the rejected license, the licensee also must waive any claims against the debtor/ licensor under the license agreement, other than a general unsecured claim.

On the other hand, upon the rejection of a license, the trustee or debtor/licensor no longer has to perform its obligations under the license, with the exception of: (i) allowing the licensee to exercise the rights retained under the rejected license; (ii) upon written request from the licensee, turning over to the licensee any intellectual property or embodiment thereof to the extent provided in the license or any supplementary agreement; and (iii) upon written request from the licensee, refraining from interfering with the licensee's rights as provided in the license or any supplementary agreement, including the right to obtain the intellectual property (or its embodiment) from another entity.

Pre-Bankruptcy Drafting to Ensure Availability of Section 365(n) Protections

Agreement as Executory

To ensure that the protections of section 365(n) are available to a licensee, it is advisable for the license agreement to specifically state that if the license agreement is determined to be an executory contract under section 365 of the Bankruptcy Code, it is an intellectual property license within the meaning of section 365(n).

Right to Terminate

Under section 365(n)(1)(A), a licensee may treat the license agreement as terminated only if the rejection of the license agreement constitutes a breach that would entitle the licensee to terminate the agreement under the terms of the agreement, applicable nonbankruptcy law or an agreement between the licensee and another entity. Therefore, it is advisable that the license agreement's definition of an "event of default" include the licensor's rejection of the license agreement under section 365(n). The license agreement also should specifically recognize the licensee's right to terminate the license agreement upon the licensor's default.

Liquidated Damages Clause

Because of the difficulties associated with ascertaining the licensee's damages resulting from the rejection, the license agreement should contain a liquidated damages clause. Such a clause would assist the parties in determining the licensee's claim for damages upon the rejection of the license agreement and may discourage the debtor from rejecting the license agreement if the liquidated damages amount is sufficiently large. The amount of liquidated damages should be reasonable, however, to avoid being characterized as a penalty which is not enforceable.

Royalties

Because a licensee must continue to make all royalty payments to a debtor/licensor if the licensee retains its rights under the license agreement, the license agreement should define "royalties" as narrowly as possible. Because courts have interpreted the term "royalty payments" broadly, the license agreement should separately identify the nature and purpose of each payment obligation under the agreement to minimize their characterization as "royalty payments" by the bankruptcy court.

Conclusion

Upon rejection of an intellectual property license, the licensee's only options under the Bankruptcy Code are to continue performing its obligations under the rejected license agreement or to terminate the agreement. As discussed above, in most instances, neither option provides the licensee with the full benefits of its pre-bankruptcy bargain. Therefore, before engaging in business with a financially troubled or start-up life sciences company, it is important to consider the risks of the transaction stemming from the potential bankruptcy of the intellectual property owner and how to protect your investment and continued use of the intellectual property if a bankruptcy occurs.