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Intellectual Property & Life Sciences

Licensee Beware: Life Sciences, Intellectual Property and Licensor's Bankruptcy

Potential for a dramatic affect

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A bankruptcy filing by a licensor of life sciences intellectual property can dramatically affect the rights that a licensee had obtained through a prebankruptcy licensing agreement. In many instances, the licensor can dramatically change the parameters of the deal and undermine the licensee's natural expectation to receive the full benefits of the bargain throughout the term of the license. When intellectual property is 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, it is particularly important for the licensee to be aware of how the licensor's bankruptcy filing can affect its rights under the licensing agreement.

The Bankruptcy Code generally allows debtors to reject executory contracts and relieve themselves of all obligations arising under such contracts, leaving the counterparty with a mere breach claim and putting them at the low end of the priority of distribution scheme. Intellectual property licenses are typically deemed executory contracts under the Bankruptcy Code. However, the Bankruptcy Code provides special treatment to executory contracts covering intellectual property and grants certain limited protections to the licensee upon the rejection of the intellectual property license. Although none of these is a perfect solution, knowledge of their rights under the Bankruptcy Code and proper prebankruptcy planning can help licensees of life sciences intellectual property mitigate the risks posed by the licensor's potential bankruptcy.

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.

Recognizing the devastating impact that a rejection of an intellectual property license can have on the licensee's business, Congress enacted section 365(n) of the Bankruptcy Code which granted a nondebtor licensee certain special protections of its interest in the intellectual property. Although a debtor typically is not required to perform its obligations under an executory contract after the bankruptcy petition is filed and pending the debtor's decision to assume or reject the contract, which the debtor can defer for months and months, 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 debtor in possession may not interfere with the rights of the licensee under the intellectual property license or any supplementary agreement.

In the event that a debtor/licensor ultimately elects 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. If the licensee treats the license as terminated, it can 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. Even if the licensee can estimate the damages caused by the rejec-

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tion, a distribution on an unsecured claim (which typically represents a small percentage of the claim, if any) does not give the licensee what it bargained for — the use of the licensed intellectual property in the operation of its business.

Alternatively, section 365(n)(1)(B) allows a licensee to retain the rights held by it under the license or any supplementary agreement at the time of the bankruptcy petition. To the extent the licensee held an exclusive right to use the intellectual property as of the bankruptcy petition date, the trustee or debtor in possession is prohibited from taking any action that curtails that right. On the other hand, section 365(n)(1)(B) specifically precludes the licensee from enforcing any contractual right to obtain any future performance under the license other than the enforcement of the exclusivity clause. Moreover, because the licensee only retains those rights that existed as of the bankruptcy filing date, if the debtor/licensor improves the licensed intellectual property post-bankruptcy, the licensee has no right to these improvements even if it had negotiated them in the license agreement. Therefore, notwithstanding the exclusivity provision in the rejected license, a debtor/licensor may develop an advanced version of the licensed intellectual property post-petition and license this property to a third party to the detriment of the existing licensee.

If the licensee chooses not to treat the license agreement as terminated, 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 contractual extensions. For this requirement to apply, it is not necessary that a payment be described as a "royalty payment" in the license agreement. Several 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.

Certain drafting points during the negotiation of the license agreement may help the licensee in a potential future dispute with the licensor as to the availability of the protections of section 365(n) of the Bankruptcy Code. Thus, 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). 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.

Frequently, it is very difficult for the licensee to determine with specificity the amount of damages resulting from the rejection of the intellectual property. Accordingly, it is advisable that the license agreement contain a liquidated damages clause. This would assist the parties in fixing the licensee's claim against the debtor's bankruptcy estate for damages resulting from the rejection of the license agreement and may, in some instances, discourage the debtor from rejecting the license agreement if the liquidated damages amount is sufficiently large. It should be noted that, to avoid being characterized as an unenforceable penalty, the amount of liquidated damages should be reasonable. In addition, since 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 reduce the likelihood that a bankruptcy court will treat them as "royalty payments.".

Licensing life sciences intellectual property from a financially troubled or start-up company carries inherent risks. As discussed above, while the Bankruptcy Code provides certain protections to the licensee, in many instances, the options provided to the licensee will not allow it to realize the full benefits of its prebankruptcy deal if the license is rejected. Before engaging in business with a financially troubled or start-up life sciences company, it behooves the licensees to consider the risks to the transaction from the potential bankruptcy of the intellectual property owner and know how to protect their investment and continued use of the intellectual property if a bankruptcy occurs. ■