

in the news

Bankruptcy and Financial Restructuring



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Alleviate the Fear of a License Counterparty Filing for Bankruptcy

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A legitimate fear among companies negotiating license agreements exists, and that is the fear of the license counterparty filing for bankruptcy. Given the business interruption that ultimately could occur as a result of a restructuring event, it is vital for practitioners to address bankruptcy or insolvency issues upfront during the negotiation of the license agreement. This is especially true for licensees who often rely heavily, if not exclusively, on a licensor for significant aspects of their business.

There are several negotiation and drafting tips that practitioners can utilize to help protect their licensee clients in the event of a bankruptcy filing under chapter 11, of Title 11, of the United States Code (the “Bankruptcy Code”) by the licensor counterparty. These include:

- Specify that all intellectual property covered by the agreement is intended to be “intellectual property” within the meaning of the Bankruptcy Code
- Specify that § 365 applies and refer specifically to § 365(n)
- Negotiate narrowly defined royalty payments and clearly differentiate royalty payments from payments for ongoing licensor affirmative obligations such as maintenance, service and upgrades
- Negotiate for a separate “supplemental” escrow agreement for source code or other embodiments of the intellectual property
- Obtain a security interest in the licensed intellectual property
- Negotiate separate agreements for the license, research, development, manufacturing, distribution and any other functions



Bankruptcy Law Framework

Section 365.

Section 365 of the Bankruptcy Code gives the debtor and debtor in possession (the “Debtor”) the option to (1) assume, (2) assume and assign, or (3) reject its unexpired leases and executory contracts in order to maximize the value of its estate. For the purposes of bankruptcy law, intellectual property licenses are generally considered to be executory contracts. Though the term “executory contract” is not defined in the Bankruptcy Code, courts generally follow the “Countryman definition,” which provides that a contract is executory when the “obligations of both parties are so far unperformed that the failure of either party to complete performance would constitute a material breach and thus excuse performance of the other.”ⁱ

The determination of whether a contract is executory is fact-specific and depends on the terms of the specific contract at issue. Courts have held that remaining payment obligations alone are not sufficient to make a contract executory.ⁱⁱ Courts have, however, held that other ongoing obligations are sufficient to deem a contract to be executory, including ongoing reporting obligations,ⁱⁱⁱ ongoing confidentiality obligations,^{iv} ongoing obligations to refrain from suing the other party for infringement of the licensed patents,^v ongoing mutual duties of cooperation in infringement actions, ongoing licensee payment obligations coupled with ongoing licensor obligations (including the duty to indemnify and defend the licensee from infringement claims and training and support obligations) and cross-licenses involving ongoing duties on each side.

Because exclusive licenses transfer a significant portion of the ownership of the intellectual property to the licensee, courts are more likely to hold that they are assignments of the interest and non-executory in nature.^{vi}

Section 365(n).

In 1988, Congress enacted section 365(n) of the Bankruptcy Code to provide protections to licensees whose licenses have been rejected by Debtor-licensors. Section 365(n) gives a non-

Debtor licensee of “intellectual property” faced with rejection the power to either treat the license as terminated or retain its rights under the license.

If the licensee elects to terminate the license in a licensor bankruptcy proceeding, the licensee may file a claim for breach of contract damages as an unsecured creditor.

Alternatively, the licensee may elect to retain its rights under the license for the term of the license and any contractual extensions, even in the face of the Debtor-licensor’s rejection of the contract.^{vii} This provision only applies to licenses of “intellectual property,” which the Bankruptcy Code defines as including patents, copyrights, trade secrets, and semi-conductor chip mask works.^{viii}

Missing from the definition are trademarks, service marks, foreign intellectual property and intellectual property created post-filing. This means that, among other things, even though section 365(n) allows a non-Debtor licensee to continue to use the underlying technology, the licensee may be barred from using developments and improvements to the technology developed after the Debtor’s bankruptcy filing.

To retain its rights, the licensee must continue to make all royalty payments to the Debtor-licensor. In determining what is considered to be a royalty payment, courts have held that the substance of the transaction rather than the label of the payment governs the determination and that payments based on the use of intellectual property or on a percentage of sales of products incorporating the intellectual property should be treated as royalty payments.^{ix} Other types of payments that the licensee may not be required to continue making include payments for ancillary services such as maintenance, technical support and marketing.



Even though the licensee has elected to retain its rights under the license, because the Debtor-licensor has elected to reject the subject license, courts have held that the licensor is relieved of ongoing future “affirmative” obligations including maintenance, technical support, marketing, and ongoing research and development, but that the Debtor-licensor is still obligated to perform its “passive” obligations under the license, including confidentiality obligations and, in the case of exclusive licenses, obligations not to license the technology to others.^x The lack of the licensee’s ability to enforce the Debtor-licensor’s affirmative obligations, however, may diminish the value of section 365(n) to licensees by significantly reducing the value of the license.

Further, section 365(n) requires that, upon request, the Debtor-licensor must turn over to the licensee source code or other licensed intellectual property if entitled under the license agreement or any supplemental agreement.^{xi} This allows the licensee to gain access to property that would otherwise remain property of the Debtor’s estate and may allow the licensee to provide the intellectual property to third-party vendors to perform support, maintenance and other functions that the licensor is no longer required to perform under the rejected contract.

Practice Tips: Licensee Negotiation and Drafting Tips

Keeping the legal framework in mind, it may be helpful to consider the following tips when negotiating a license agreement on behalf of a licensee.

- (1) **Specify that all intellectual property covered by the agreement is intended to be “intellectual property” within the meaning of the Bankruptcy Code, for example:**

“All rights and licenses granted pursuant to any section of this Agreement, including without limitation, all rights and licenses to use improvements or enhancements developed during the term of this Agreement, are intended to be, and shall be deemed to be, for purposes of § 365(n) of the Bankruptcy Code, licenses of rights to “intellectual property” as defined under § 101(35A) of the Bankruptcy Code.”

This provision may help the licensee argue that, even if certain pieces of the subject intellectual property are not included in the Bankruptcy Code’s definition of intellectual property (e.g., trademarks and intellectual property developed post-filing), the parties intended that the licensee be afforded the protections of § 365(n) for all of it.

- (2) **Specify that § 365 applies and refer specifically to § 365(n), for example:**

“Section 365(n) of the Bankruptcy Code shall be implicated by any rejection or proposed rejection of this Agreement by Licensor in any bankruptcy proceeding, and Licensee shall have the right to retain and fully exercise all of its rights hereunder in spite of any such proceeding. All of the rights granted to Licensee under this Agreement shall be deemed to exist immediately before the occurrence of any bankruptcy case in which Licensor is a debtor. Licensee shall retain and may fully exercise all of its rights and elections under the Bankruptcy Code or equivalent legislation in any other jurisdiction. Without limiting the foregoing, Licensor acknowledges that the rights and license granted to Licensee pursuant to this Agreement shall not be affected by the rejection of this Agreement in bankruptcy, and shall continue subject to the terms and conditions of this Agreement. In the event that this Agreement is rejected or deemed rejected in a bankruptcy proceeding (a “Rejection”), Licensor shall provide written notice thereof to Licensee. In the event that Licensee makes no election under § 365(n) of the Bankruptcy Code within sixty (60) days following written notice of such Rejection to either treat the contract as terminated, or to retain its rights, Licensee shall be deemed to have made a formal election (i) to



retain its rights under § 365(n)(1)(B), (ii) to demand that the trustee in such bankruptcy provide to Licensee any intellectual property held by such trustee that is subject to the contract (including any embodiment of such intellectual property), and to not interfere with the rights of Licensee as provided in such contract, under § 365(n)(3)(A) of the Bankruptcy Code; and (iii) to the extent any rights of Licensee under this Agreement are determined by a bankruptcy court not to be “intellectual property rights” for purposes of § 365(n) of the Bankruptcy Code, all of such rights shall remain vested in and fully retained by Licensee after any such Rejection. Licensee shall under no circumstances be required to terminate this Agreement after a Rejection in order to enjoy or acquire any of its rights under this Agreement.”

(3) **Negotiate narrowly defined royalty payments and clearly differentiate royalty payments from payments for ongoing licensor affirmative obligations such as maintenance, service and upgrades, for example:**

“The parties agree that the payments owed hereunder are not intended to be “royalty” payments under § 365(n)(2)(b) of the Bankruptcy Code and instead, such payments are intended to be in consideration of the continuing affirmative obligations of performance on the part of Licensor.”

If a licensee elects to retain its rights under a rejected license, a clause limiting the definition of “royalty” payments could limit the payments the licensee would be obligated to continue to make in order to retain such rights.

Or, in the alternative, add language specifying that payments will be reduced to the extent that Licensor’s services are reduced, for example:

“Any continuing payments required to be made by Licensee hereunder shall be equitably reduced to reflect the loss of any services or other rights of Licensee or obligations of Licensor that are terminated as a result of Licensor’s rejection or proposed rejection of this Agreement in the event of a Licensor bankruptcy.”

If a licensor will not agree to the first clause, then this clause could have a similar effect of reducing the amount of the ongoing payments a licensee will be required to make to retain its rights under the license pursuant to § 365(n) of the Bankruptcy Code.

(4) **Negotiate for a separate “supplemental” escrow agreement for source code or other embodiments of the intellectual property (e.g., designs and drawings) accompanied by a license to use such materials, for example:**

“Escrow. The parties shall enter into the supplemental escrow agreement attached hereto as Exhibit A (the “Escrow Agreement”) with Escrow Agent, and shall make Licensee a beneficiary of such Escrow Agreement, to maintain at least one copy of the Escrowed Materials (as defined therein). Licensor shall update the Escrowed Materials from time to time. The Escrow Agreement will provide that, upon Licensee’s request, Licensee shall be entitled to receive a copy of all Escrowed Materials immediately upon the commencement of any voluntary proceeding under any bankruptcy law by Licensor or the commencement of any involuntary proceeding under any bankruptcy law against Licensor which is not discharged within sixty (60) days (an “Escrow Release Event”). Upon an Escrow Release Event, Licensor hereby grants to Licensee a perpetual, irrevocable, royalty-free, fully paid up, worldwide, non-exclusive license under all intellectual property rights owned or controlled by Licensor to make, have made, use, reproduce and prepare (and have prepared) derivative works of the Escrowed Materials.”

(5) **Obtain a security interest in the licensed intellectual property.**



This would increase the priority of the licensee's claims for breach of the license, thereby increasing the likelihood that such claims will be paid in full.

(6) Negotiate separate agreements for the license, research, development, manufacturing, distribution and any other functions.

Separating all of the functions into distinct agreements could help bolster a licensee's argument that each agreement is non-executory, thereby removing the licensor's ability to reject any of them in bankruptcy.

However, please be advised that recently, courts have held that even if contracts are separate, if they are so inextricably intertwined and cannot be formed without each other, then they must constitute one contract.

Courts have looked at the parties' intent based on the language of the agreement(s) and the surrounding circumstances at the time of entering into the agreement in making such a determination.^{xii}

Given the unpredictability of a counterparty's financial condition over time, all contracts and agreements should be drafted with a potential bankruptcy filing in mind. This is especially true when it comes to protecting a licensee's interest in important intangible intellectual property assets, such as patents and trademarks. Utilizing the foregoing drafting techniques will not guarantee success in the event of a bankruptcy filing by a licensor; however, such techniques should strengthen your legal arguments and help provide you with peace of mind even upon receiving unexpected notice of your counterparty's bankruptcy filing.



For More Information

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ⁱ V. Countryman, *Executory Contracts in Bankruptcy*, 57 MINN. L. REV. 439 (1973).

ⁱⁱ *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043, 1046 (4th Cir. 1986).

ⁱⁱⁱ *Id.*

^{iv} *In re Aerobox Composite Structures, LLC*, 373 B.R. 135, 139 (Bankr. D.N.M. 2007).

^v *In re Access Beyond Tech., Inc.*, 237 B.R. 32, 43 (Bankr. D. Del. 1999).

^{vi} See, e.g., *In re Particle Drilling Techs., Inc.*, 2009 WL 2382030 (Bankr. S.D. Tex. Jul. 29, 2009).

^{vii} 11 U.S.C. § 365(n) (2015).

^{viii} *Id.* § 101(35A).

^{ix} *In re Prize Frize, Inc.*, 150 B.R. 456, 459-460 (9th Cir. BAP Feb. 11, 1993). The *Prize* court noted in its dicta that fees should not be considered royalty fees to the extent they are in consideration for continuing affirmative obligations of performance on the part of the Debtor-licensor, such as warranties and indemnification agreements.

^x *In re Szombathy*, 1996 WL 417121, at *9 (Bankr. N.D.Ill. 1996), *rev'd in part on other grounds, Szombathy v. Controlled Shredders, Inc.*, 1997 WL 189314 (N.D. Ill. 1997).

^{xi} 11 U.S.C. § 365(n)(3).

^{xii} *In re Am. Home Mortg., Inc.*, 379 B.R. 503, 521 (Bankr. D. Del. 2008).



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