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Some going concerns: A primer on intellectual property issues in bankruptcy for licensors and licensees

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Much has been written on the myriad of legal issues emanating from the global COVID-19 pandemic: the constitutionality of the lockdowns, liability for stores that open, the process of obtaining PPP loans, and the applicability of force majeure clauses, to name a few.

As intellectual property and bankruptcy practitioners, we are fielding more questions regarding the impact of bankruptcies (both actual and potential) on the rights of licensors and licensees.

This article highlights some of the most frequently raised issues, both for licensors and licensees evaluating their rights due to a recent or pending bankruptcy filing, as well as for parties re-evaluating their risk profiles when entering into new license agreements amid the COVID-19 pandemic.

We also explore some of the pitfalls of source code escrow agreements and the impact of a release of source code due to a bankruptcy filing.

RIGHTS OF A LICENSOR WHEN A LICENSEE ENTERS BANKRUPTCY

Generally, a license agreement is like any other contract in that it can be terminated upon the mutual agreement of the parties or as otherwise set forth in its terms (typically for a party's uncured breach or upon expiration).

Many license agreements contain language purporting to authorize a party to terminate such a contract upon the counterparty's insolvency or filing for bankruptcy (known as "ipso facto" clauses).

However, such clauses are typically unenforceable in executory contracts (i.e. contracts where material performance obligations remain due on both sides) when a counterparty files a chapter 11 or chapter 7 case under the United States Bankruptcy Code (the "Bankruptcy Code") as the Bankruptcy Code generally forbids the termination of such a contract (and a party's rights or obligations thereunder) based solely on the debtor counterparty's insolvency or the commencement of a bankruptcy case under the Bankruptcy Code, whether or not on such a termination right exists in the contract.[1]

This is logical, because the Bankruptcy Code seeks to preserve the rights of the debtor/bankruptcy estate so that the business may continue uninterrupted while the trustee (in a chapter 7 case) or "debtor-in-possession" (in a chapter 11 reorganization case)[2] decides what contracts should be "assumed" (and continue to be performed under) or what contracts should be "rejected".

In the intellectual property context, the prohibition on the enforcement of *ipso facto* clauses combined with the Bankruptcy Code's automatic stay is often critical as such provisions prevent a non-debtor licensor from terminating a debtor licensee's right to use intellectual property needed to operate (such as a license for infrastructure software) upon the commencement of a bankruptcy proceeding.

Licensed rights of intellectual property (whether a patent, copyright, trademark, trade secret, publicity, or otherwise) are not typically assignable by a licensee without the consent of the licensor under non-bankruptcy law.

> It is critical for a licensor and licensee to closely review and critically negotiate all intellectual property contract/license agreement provisions, including those provisions relating to assignment and termination upon bankruptcy.

The Bankruptcy Code specifically states a trustee of a bankruptcy estate may not assign a contract where the default position under applicable non-bankruptcy law is to excuse the counterparty to the agreement from accepting such an assignment.[3]

Thus, although a non-debtor licensor cannot terminate a license simply due to a debtor licensee's insolvency or filing of a bankruptcy petition under the Bankruptcy Code, such non-debtor licensor may ultimately prevent the debtor licensee from assigning its interest to a third party.

Such non-debtor licensor may then ultimately be able to seek relief from the Bankruptcy Code's automatic stay to terminate the license that cannot be assigned, and arguably therefore cannot be assumed.[4]

However, where the license agreement expressly allows the licensee to assign the license agreement (whether generally or specifically in connection with a sale of all or substantially all of the licensee's assets), then an executory intellectual property license would likely be assignable under applicable law and such a contract would not be terminable by the licensor.

Thus, it is critical for a licensor and licensee to closely review and critically negotiate all intellectual property contract/license agreement provisions, including those provisions relating to assignment and termination upon bankruptcy.

RIGHTS OF A NON-DEBTOR LICENSEE WHEN A DEBTOR LICENSOR ENTERS BANKRUPTCY

Under the Bankruptcy Code, a debtor (in a chapter 11 bankruptcy) or chapter 7 trustee (in a chapter 7 liquidation) has broad authority, upon approval of the court, to assume (*i.e.* accept) or reject (*i.e.* deem the contract breached)[5] executory contracts of the bankruptcy estate in order to maximize the value of the debtor's assets for the benefit of its bankruptcy estate.[6]

When a debtor enters bankruptcy, the trustee/debtor may believe that the best way to preserve the value of the bankruptcy estate is to terminate any outstanding license agreements (to the extent possible) in order to increase the value of the bankruptcy estate's intellectual property.

However, section 365(n) of the Bankruptcy Code protects the rights of intellectual property non-debtor licensees by giving the licensee the ability to (a) accept any such rejection of the contract by the debtor licensor, or (b) retain the licensee's rights under such intellectual property license despite the rejection of such contract.[7]

Although allowing for a unilateral rejection of the license by the debtor licensor could increase the value of the bankruptcy estate's applicable intellectual property assets, allowing such rejection without protecting the rights of counterparty non-debtor licensees would be too disruptive for licensees, and could result in substantial consequences for these downstream licensees.

Such consequences could include potentially bankrupting a licensee that would no longer be able to conduct its business if its license rights could so easily be vaporized.

Since the Bankruptcy Code not only seeks to preserve the value of a business as a going concern and the rights of creditors, but also to minimize the effects of a bankruptcy filing on the rest of the economic ecosystem, the inclusion of these provisions in the Bankruptcy Code is logical and necessary.

If the non-debtor licensee chooses to retain its contractual rights upon a license agreement's rejection by a debtor licensor, the licensee will need to continue making any payments required under the license agreement to the bankruptcy estate.

The applicable intellectual property assets that are subject to the license may be sold during the bankruptcy proceedings, and the license would be transferred with them.

Note that the restrictions noted above regarding the non-assignability of an intellectual property license by a debtor licensee would not apply, as the default rule preventing the assignment of intellectual property licenses is only for licensees, while licensors may generally assign their interests under applicable non-bankruptcy law.

In such circumstances, the license would need to be transferred with the intellectual property, and the assignee will step into the shoes of the previous licensor.

One question that is often raised is whether an exclusive license is converted to a non-exclusive license as a result of the bankruptcy of the licensor.

Although this may sound like a reasonable approach for the Bankruptcy Code to have taken (essentially treating the licensee as another creditor and limiting its recovery), the provisions of section 365(n) of the Bankruptcy Code expressly state that exclusivity rights of a non-debtor licensee shall continue to be effective if the licensee elects to retain its intellectual property rights despite rejection of the license agreement in the bankruptcy proceedings.

One question that is often raised is whether an exclusive license is converted to a non-exclusive license as a result of the bankruptcy of the licensor.

The protections of section 365(n) of the Bankruptcy Code only apply to "intellectual property." However, the Bankruptcy Code does not clearly delineate all categories of intellectual property that would be protected by section 365(n).

Accordingly, licensees of intellectual property should include language such as the below in their license agreements to make clear that such licenses are intended to fall within the definition of "intellectual property" subject to the important protections of section 365(n) of the Bankruptcy Code:

Bankruptcy Protection. The parties agree that all of the rights to any [Licensed Materials] hereunder constitute "intellectual property" as defined in Section 101(35A) of the United States Bankruptcy Code (the "Bankruptcy Code") and that this Agreement shall be governed by Section 365(n) of the Bankruptcy Code. If [Licensor] voluntarily or involuntarily becomes subject to the protection of the Bankruptcy Code, and [Licensor] or the trustee in bankruptcy rejects this Agreement under Section 365 of the Bankruptcy Code, [Licensee] shall have the right to: (i) treat this Agreement as terminated; or (ii) retain [Licensee's] rights under this Agreement, specifically including, without limitation, the right to exercise its rights granted herein to such [Licensed Materials].

SOURCE CODE ESCROW

Another hot topic is the impact of a bankruptcy on an agreement that includes a source code escrow provision. Software is typically licensed solely in object code form (i.e., the form readable by a computer, but not understandable by humans), rather than as source code (i.e., human readable).

When licensing software that is material to its business, a licensee should seek to have the licensor place the source code for the applicable software into escrow with a third-party agent (such as Iron Mountain).

Pursuant to an agreement between the licensor and the escrow agent, the agent will release the source code under certain limited conditions negotiated between the licensor and the licensee in the underlying license agreement (most typically, conditions relating to circumstances where the licensor no longer supports or maintains the software).

The vast majority of software licensors rightly seek to maintain the secrecy of that software's source code. Businesses built entirely around their proprietary software consider their source code to be the company's crown jewels and are often very reluctant to make it available under any circumstances, including in escrow.

Nevertheless, licensors providing critical software often find such escrow provisions necessary in order to close the deal with their customers.

The conditions triggering the release of source code pursuant to an escrow provision may include the bankruptcy of the licensor or the assignment of the applicable license agreement by the licensor. Both of these concepts may be implicated by a bankruptcy filing and should be taken into consideration prior to any voluntary bankruptcy filing occurring.

Although no company wants to consider a potential bankruptcy when negotiating a license agreement with a potential licensee (and over-arguing on such contingencies may be viewed as a weakness of the licensor's business to the licensee), it is important for licensors not to allow such release conditions to be triggered too easily.

A useful strategy for licensors when negotiating release conditions and rights of a licensee following such a release is to focus on the respective parties' shared interests rather than the consequences of a bankruptcy and/or release of source code.

By highlighting the goal of maintaining business continuity for a licensee — and that the licensee may not be in a position to maintain and support the software itself if the source code is released — the parties should be able to reach a reasonable middle-ground on the release conditions and the terms surrounding the usage of the source code thereafter.

It should be noted that the release of source code from an escrow account is not the same as a transfer in ownership. Nevertheless, licensors and licensees need to carefully draft source code escrow provisions in their underlying license agreement to ensure that their interests are adequately protected.

In a properly drafted escrow provision, the source code should remain the intellectual property and confidential information of the licensor, and the licensee would have the right to use such source code only to the extent still allowed under (and for the remainder of) the applicable license agreement.

In the context of a bankruptcy, acquirers of the intellectual property rights and source code of the bankruptcy estate typically consider such assets' value to have diminished substantially upon any source code release.

This is the case even when the provisions of a source code escrow agreement require the licensee to maintain the source code's confidentiality upon release or other reasonable restrictions.

Another hot topic is the impact of a bankruptcy on an agreement that includes a source code escrow provision.

For this reason, a potential acquiror of such intellectual property assets from a bankruptcy estate may seek to come to an agreement with any potential recipients of the source code in escrow to avoid its release if the acquiror agrees to maintain the software for the licensees following the purchase and/or provide additional consideration.

LOOKING FORWARD

Whether analyzing rights with a licensor impacted by the current pandemic or exploring a new business opportunity with a counterparty, it is important for businesses relying on the value of intellectual property to consider and appropriately address the interplay between bankruptcy and intellectual property law, and how such interplay affects their related commercial intellectual property agreements.

Although the Bankruptcy Code may override certain provisions in a contract, the parties to intellectual property licenses have great latitude to plan for many scenarios, and potentially mitigate their respective risks, by negotiating contractual provisions to protect their respective rights in the event that a contract counterparty undergoes a bankruptcy.

Although it may be unpleasant to negotiate and plan for the bankruptcy of either party to a license, such initial additional efforts will prove worthwhile in the long run should a bankruptcy become a reality.

NOTES

[1] See 11 U.S.C. § 365(e)(1). However, 11 U.S.C. § 365(e)(2) contains an important exception to this general rule limiting section 365(e)(1) in situations where the non-debtor contract counterparty is excused from accepting performance from or rendering performance to an assignee of such contract or lease. As a result, section 365(e)(1) does not impact ipso facto clauses in those contracts that are not assignable under applicable non-bankruptcy law. See generally 3 COLLIER ¶ 365.07[1] at 365-67 (stating that "§ 365(e)(2) provides that the invalidation of ipso facto clauses does not apply to contracts or leases that are non-assignable under applicable non-bankruptcy law"). However, the non-debtor licensor will not be able to immediately terminate a licensee's rights following a bankruptcy filing due to the automatic stay protection provided under 11 U.S.C. § 362(a) the Bankruptcy Code, although the non-debtor licensor is not obligated to accept the assignment of the license in the bankruptcy proceedings, and may subsequently seek relief from the automatic stay to terminate the license under an ipso facto clause or other termination for breach provisions in such license.

[2] In a chapter 7 liquidation, a chapter 7 trustee is appointed to take over the debtor and maximize the value of the debtor's assets for the benefit of the debtor's "estate". In a chapter 11 reorganization, typically no trustee is appointed and the debtor continues to run its business as a "debtor-in-possession". The Bankruptcy Code gives certain rights and powers to a "trustee". In a chapter 7 case, such rights are exercised by the appointed chapter 7 trustee. In a chapter 11 case, such rights are exercised by the debtor company (unless a chapter 11 trustee is appointed for cause such as due fraud, dishonesty, incompetence, gross mismanagement, or the like).

[3] See 11 U.S.C. § 365(c)(1)(a).

[4] There is a split in the bankruptcy case law whether a contract that cannot be assigned also cannot be assumed, which has implications for a debtor seeking to reorganize under chapter 11 of the Bankruptcy Code. Thus, an analysis of licensor and licensee rights needs to be performed depending on the location where the bankruptcy case is filed.

[5] Certain courts had historically treated "rejection" of an executory contract as akin to termination of such contract and the counterparty's rights thereunder. However, the Supreme Court in *Mission Product Holdings, Inc. v. Tempnology, LLC*, 587 U.S. ___, 139 S. Ct. 1652, 203 L.Ed.2d 876 (2019) held that rejection of an executory contract is akin to breach of such contract outside of bankruptcy. *See* Mission Product: Supreme Court Protects Rights of Trademark Licensees in Bankruptcy Despite "Rejection" of Underlying Trademark License Agreement by Debtor-Licensor, available at https://bit.ly/3hyyXc2.

[6] See 11 U.S.C. § 365(a).

[7] While the non-debtor licensee can retain its intellectual property rights, such rights would only exist as of the bankruptcy filing (so the licensee likely will not be able to force debtor-licensor to take affirmative actions under the contract such as providing maintenance, updates, support or even defend the intellectual property). Additionally, other related non-intellectual property rights under the license agreement such as the right to distribute products may be found by a court to not fundamentally be subject to the protections under section 365(n) of the Bankruptcy Code.

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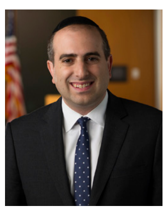

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