Licensees And Licensors Need To Prepare For Potential Bankruptcies Caused By COVID-19

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We are in unprecedented times. The current COVID-19 pandemic will not only have an impact on the physical health of our country, but the economic health of our country as well. Increased bankruptcy filings are a virtually certainty and this raises concerns of many, including licensors and licensees of intellectual property. What should these parties be thinking about given the coming uptick in bankruptcies?

From the Licensee’s Perspective

First, let’s analyze the issue from the standpoint of a licensee under an intellectual property license agreement where the licensor files bankruptcy. Intellectual property licenses are typically considered to be executory contracts. This means that the licensor debtor may reject, assume, or assume and assign an intellectual property license agreement.

If the licensor debtor elects to reject the license agreement, the Bankruptcy Code provides special protection to the non-debtor licensee. Specifically, section 365(n) provides that if a debtor rejects an executory contract under which the debtor is a licensor of intellectual property, the licensee may either: (1) elect to treat the contract as terminated (i.e., breached), and file a proof of claim for damages flowing...
from the debtor’s termination of the contract; or (2) retain its rights to use the intellectual property under the contract for the duration of the contract and for any extension periods provided for by the contract. If the non-debtor licensee elects to retain its rights to the intellectual property, the licensee must continue to make all royalty payments due under the original term of the contract, and any term extensions that the licensee elects to exercise. The debtor-licensor must, upon written request of the licensee: (a) comply with any contractual requirement to provide the intellectual property to the licensee; and (b) refrain from interfering with the rights of the licensee to the intellectual property.

What steps should the non-debtor licensee take if it wants to retain its rights under the license agreement? The licensee should not wait for the debtor-licensor’s rejection of the agreement if it has already decided that it wants to retain its rights to the intellectual property. Instead, the licensee should be proactive and provide written notice to the debtor licensor, thus ensuring its continued access to the intellectual property.

From the Licensor’s Perspective

Second, let’s analyze the debtor licensee who wants to assume and assign the license agreement. What are the licensor’s rights in such a circumstance?

Generally speaking, a contract cannot prohibit assignment. However, section 365(c)(1) of the Bankruptcy Code provides one exception to this general rule of assignability by providing that a debtor “may not assume or assign” an executory contract or unexpired lease if “applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor” and “such party does not consent to such assumption or assignment.” The term “applicable law” includes patent laws—and under U.S. patent law, a nonexclusive license is considered to be personal and not assignable without the patent owner’s consent.

What are the implications of Section 365(c)(1)? The short answer is it depends on where the bankruptcy case is filed, as there are two primary frameworks under which the courts address the issue. Those courts applying the “actual test” (the First and Fifth Circuits, and lower courts in the Seventh, Eighth, and Tenth Circuits) hold that section 365(c)(1) bars the assumption of a contract only if the debtor actually intends to also assign the contract. So, if a debtor licensee intends only to assume the agreement, and not to assign it, the licensor cannot use section 365(c)(1) to prevent assumption of the license agreement, and the licensor may have to continue to permit the debtor to perform under the agreement.

In contrast, those courts applying the “hypothetical test” (the Third, Fourth, Ninth, and Eleventh Circuits) hold that section 365(c)(1) bars the assumption of a contract, even if the debtor has no intention of assigning the agreement. These courts therefore ask whether the debtor could hypothetically assign the agreement over the objection of the licensor. The hypothetical test provides enormous power to the licensor since the licensor can prevent assumption of the agreement even if the debtor licensee has no intention of assigning the agreement.

Protecting Licensee and Licensor Interests
With this in mind, what should intellectual property licensees and licensors do to protect their interests given the current economic downturn? Well, if these parties are about to enter into, or are presently negotiating, these agreements, there are a number of steps such parties should consider now. Perhaps the first and most obvious is to undertake careful due diligence into the financial status of the other party prior to consummating a license transaction. Typically, a license agreement is not the kind of agreement that is preceded by in-depth due diligence, but this may need to change in the foreseeable future, in particular if a licensor is being asked to grant an exclusive license and thereby forgo other revenue opportunities with other potential licensees.

From the perspective of the licensor, paying close attention to termination rights also makes sense. While common in almost all license agreements, clauses known as an *ipso facto* termination provision that provide for termination due to the bankruptcy, insolvency, or financial condition of the licensee are generally unenforceable. However, it may be possible to circumvent such prohibitions and achieve a similar result through other strict termination clauses that, for example, allow termination due to failure to make royalty payments on time or to meet minimum royalty requirements. Licensors should also consider granting a license not to the licensee directly, but to a special purpose vehicle established primarily for this purpose that is more insulated from the potential financial woes of the actual interested licensee. These kind of arrangements can be complex and raise numerous corporate and tax issues that will require careful analysis.

From the perspective of the licensee, and in particular in the context of software licenses, including possibly hosted Cloud-based arrangements, licensees should consider bolstering the protection afforded by section 365(n) with a separate source code escrow arrangement that requires the licensor to deposit the source code of the licensed software and other related materials with an independent third party escrow agent. This is particularly important where the licensed software is critical to the licensee’s operations and where the licensor is also responsible for providing needed support and maintenance services. If a financially distressed licensor eventually proves unable to provide such services, access to the source code may become essential to the licensee’s ability to continue to use the licensed software.

**Source Code and Other Escrow Arrangements**

It is important to note that an escrow agreement is a “supplementary agreement” under section 365(n), and as such a licensee’s rights under the escrow agreement continue to be enforceable in a bankruptcy situation. In negotiating an escrow agreement, licensees should give careful attention to the following issues:

- An escrow agreement is typically a three-party agreement between the licensor, the licensee and the escrow agent. Often these agreements are based on the agent’s standard form but such forms leave important issues to the discretion of the other parties. The licensee and licensor will both want to use a recognized and reputable escrow agent; moreover, the licensee should insist on finalizing and executing the escrow agreement contemporarily with the underlying license agreement. Delays in this context may result in a loss of leverage and, thus, more favorable terms for the licensor.
In addition to bankruptcy and other insolvency related conditions, a licensee will want additional “release triggers” that allow access to the escrowed materials. Such triggers may include an ongoing failure to provide the required services or a cessation of the licensor’s business activities. Such events may be related to financial distress of the licensor, but this is not necessarily the case.

In addition to favorable release triggers, a licensee will want an efficient and speedy release mechanism. Ideally, a licensee should insist on release subject only to written notification to the escrow agent (e.g., upon ten days prior written notice to the licensor). The licensee should try to limit the ability of a licensor to institute arbitration or legal proceedings by objecting to the notice.

The escrowed materials should be periodically updated and supplemented as the licensed software is enhanced and modified.

Use of source code and other materials from escrow will require a license from the licensor. This license should be broad enough to allow the licensee to share the materials and seek assistance from independent consultants with the requisite level of expertise. One point often made regarding the usefulness of escrow arrangements is that many licensees may not have the wherewithal to understand how to effectively use the released materials. This problem can be addressed through broad license terms.

Conclusion

The current COVID-19 pandemic will increase bankruptcy filings and thereby impact licensors and licensees of intellectual property. Licensors and licensees are advised to evaluate the provisions of their license agreements and proactively assess revisions and provisions for continued licensing arrangements. The above suggestions will not altogether eliminate the risks of doing business with financially distressed companies, but they should help to mitigate these risks, which, unfortunately, are only likely to increase as more and more companies are impacted by the financial fallout from the COVID-19 crisis.

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