

The following article appeared in *Executive Counsel*.

Protect Your IP Licensing Agreement *Bankruptcies Disrupt Counterparty Relationships* By Stanton J. Lovenworth and Doron S. Goldstein

For companies whose business relies on licensed intellectual property, the inability of counterparties to perform — or worse, their bankruptcy — can cause significant harm. Unlike suppliers who can be replaced, IP licensors provide a unique property, one that would require significant time and capital to replace, if indeed it could be replaced at all.

As a general matter, licensees of intellectual property are protected from the bankruptcy of licensors by the Bankruptcy Code, which allows licensees to continue to exploit the IP for the duration of the license and any applicable extensions.

It is important to note, however, that the rights are only to intellectual property covered by the license, and in existence prior to the bankruptcy filing. Trademarks are not included within the definition of intellectual property in the Bankruptcy Code, so trademark licensees cannot benefit from protection.

Under the terms of protection, the licensor does not have to perform any other obligations that may exist in the agreement, such as making filings, paying fees, or taking action against third-party infringers. Even though the failure to provide these services can significantly reduce the value of the licensed IP, the licensee will likely have only a claim of damages for breach of contract against the licensor. Moreover, it will be an unsecured claim likely resulting in little or no monetary recovery.

It is important to remember that licensee protections under the Bankruptcy Code are not automatic. The licensee must take action to retain its rights once the licensor has filed for bankruptcy protection.

The bankruptcy of an IP licensee, particularly an exclusive licensee, can cause substantial or even fatal harm to the licensor. Nevertheless, licensors do not benefit from the protections that the Bankruptcy Code affords licensees. Because

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of the unique nature of IP rights, licensors often have a significant interest in terminating or otherwise resolving the status of agreements with bankrupt licensees as quickly as possible. Licensed trademarks can be damaged by association with a bankrupt entity, and could be undermined if quality control has failed.

In addition, the termination or suspension of payments under an exclusive license for the duration of bankruptcy proceedings may cause traumatic financial losses, without allowing the licensor to mitigate those damages by finding another licensee. While there are bankruptcy procedures that allow for some relief in those cases, it may not come quickly enough for licensors caught in the process.

Basic Cautions For Current Licenses

- Don't waste time if the counterparty defaults. Give serious consideration to sending a notice of breach or default immediately. You may not be able to terminate once the bankruptcy filing has been made, even if the counterparty was in default before filing.
- Continuously monitor any materials that you receive, and ensure that documents and software are promptly delivered. This is particularly important with respect to software source code, which licensors routinely fail to update with the most recent versions.
- Even if you are not facing the imminent bankruptcy of a counterparty, consider your existing relationships to determine whether any key IP agreements may warrant revision to provide additional protections. Although obtaining such changes may entail making concessions, adding some of the provisions outlined below may provide significant additional benefit and security.

Checklist For New Licensing Agreements

The possibility of bankruptcy should be an integral consideration when structuring a new relationship for key IP. The best options for protecting yourself from the bankruptcy of a counterparty occur before the deal is signed.

Regardless of whether you are the licensor or licensee, consider the following in any new license arrangement:

- Be careful of evergreen provisions. While it is much easier to have agreements that are long-term or automatically renew unless one party gives notice, with such agreements, in bankruptcy a notice of termination may not be effective.
- Include pre-bankruptcy triggers allowing modification or termination of the license. In general, provisions in an agreement that are triggered by bankruptcy are unenforceable "ipso facto" clauses under US bankruptcy law. However, specific financial or performance-related triggers may be used to terminate the license or alter its nature. These may avoid being characterized as ipso facto provisions if the trigger is prior to bankruptcy.

This article is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

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It is helpful to make these provisions automatic, so that even if you fail to provide notice, the effect has already taken place. Triggers could include failure to meet specific financial tests, make minimum sales or timely payment.

- Transfer the IP to a separate company. One of the best protections against the bankruptcy of a licensor is having the licensor assign the IP to a holding company, whose sole purpose is managing IP. The purpose is to create an entity that is remote from the operating company, and would not be impacted by the bankruptcy of the operating company. This process is used regularly in IP royalty securitization. Properly implementing the assignment is critical. If the transfer is not done properly, a bankruptcy court may consolidate the entities, thus eliminating the protection.
- Form a joint venture. Like a separate holding company, a joint venture could move the IP in question outside the reach of a licensor's bankruptcy. The specifics of the structure would obviously be subject to negotiation, but could reduce the potential consolidation issues.
- Get a security interest in the IP to secure performance. While in another economic environment these types of transactions were rare, now they are occurring more regularly. They serve as incentive for the licensee to enter into the transaction or make payments up front. If the security interest is ever exercised, it likely will be in a situation where the licensor is already facing far greater issues.
- Consider source code escrow. For software-related licenses, requiring the licensor to place the source code in the hands of a third-party escrow agent has become routine. The specific language of the escrow creation and release conditions should be carefully considered. The standard agreements of some escrow providers may not be sufficient for bankruptcy protection. In addition, consider whether additional information, such as development documentation and/or annotation will be necessary. If it is not included within the source code it must be separately included in the escrowed property.
- In certain situations, a licensee may be able to obtain other protections. The current economic environment has made parties more aware of the possible failure of counterparties, and may provide an incentive for some creative solutions. Options include joint ownership of all or part of the IP in question, or even a transfer of ownership and license back.

While a counterparty's bankruptcy is always problematic, proper planning and action at all stages of the relationship can help mitigate the impact. Creative structuring and monitoring can significantly limit the adverse impact on the solvent party.