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King & Spalding

COVID-19 – Take Action Now to Protect Intellectual Property Rights During Bankruptcy

NAVIGATING THROUGH A NEW ENVIRONMENT

It is no secret that the outbreak of the coronavirus has caused untold damage, distress, and dislocation to the worldwide economy, leading many companies to consider their respective restructuring options.

Given the current climate and economic uncertainty, now is the time to review commercial and technology transaction agreements to determine the effects that a bankruptcy filing may have on critical components of intellectual property rights ("IP Rights") that are being licensed to, or licensed by, a potential debtor in a chapter 11 bankruptcy filing. This article provides (i) an overview of the treatment of IP Rights in bankruptcy, including the treatment of executory intellectual property contracts in bankruptcy, and (ii) proactive steps that counterparties to intellectual property agreements can take to protect their respective positions in advance of a bankruptcy filing by a contract counterparty.

WHAT IT MEANS TO REJECT THE CONTRACT IN BANKRUPTCY

Generally speaking, the U.S. Bankruptcy Code (11 U.S.C. Section 365) allows a debtor in a bankruptcy (subject to court approval) to assume (or assume and assign to a third party) or reject any "executory contract" of the debtor. In this context, an executory contract means one for which material obligations remain due on both sides.

If a debtor elects to assume such contract, then the U.S. Bankruptcy Code requires that the debtor cure any defaults thereunder (or provide adequate assurance of a prompt cure). This essentially means that the debtor will pay any amounts due under that contract and the contract will continue in full force between the debtor – or an assignee – and the applicable counterparty. If a debtor elects to reject such contract, the effect of rejection is that (i) the debtor no longer has to perform its obligations thereunder, (ii) the rejection constitutes a breach (not termination) of the contract immediately before the date of the bankruptcy filing (so the counterparty has the rights provided by the contract in the

event of a breach, not a termination) and (iii) the rejection gives rise to a claim for damages by the non-breaching party (and such claim is afforded the same treatment in the bankruptcy case to all other unsecured claims, which oftentimes means that it receives a fraction of its claim amount).

TREATMENT OF IP RIGHTS AND RELATED AGREEMENTS UNDER THE BANKRUPTCY CODE

The treatment of intellectual property executory contracts in U.S. bankruptcy is a deviation from the general rule that a debtor can freely assume and assign executory contracts leaving the contract counterparty with solely an unsecured claim for damages. ***If the debtor is the licensee***, the debtor's ability to assume and assign an intellectual property executory contract depends on where the bankruptcy case has been filed in the United States, as certain courts have found that a licensor that does not consent to the assignment can successfully block a debtor licensee from assigning a patent, copyright or trademark license to a third party during a bankruptcy case.

With respect to the debtor as a licensor, Section 365(n) of the Bankruptcy Code provides specific protections. To qualify under Section 365(n), the contract in question must be both (i) for "intellectual property," as defined in the bankruptcy code and (ii) an executory contract.

(i) ***"Intellectual property" means*** (i) trade secret, (ii) invention, process, design, or plant protected under title 35; (iii) patent application; (iv) plant variety; (vi) certain work of authorship; or (vii) certain mask work (relating to semiconductor chip product). This definition does not include (i) trademarks,[1] (ii) trade names, (iii) service mark licenses and (iv) foreign patents and copyrights.

(ii) ***With respect to the executory nature of intellectual property contracts***, courts generally take a broad view of ongoing obligations and have found that the grant of a license itself is intended to be a continuing obligation not to sue the licensee, and defending claims of infringement have been found sufficient to create an executory contract. With respect to the licensee, the duty to pay royalties, confidentiality and indemnification obligations have all been held to be material ongoing obligations.

If a contract meets the requirements of Section 365(n), that provision provides that, until the debtor licensor rejects an intellectual property agreement, at the licensee's request, the debtor licensor must (to the extent provided in such agreement) either perform under the contract or provide the licensee with the intellectual property (again, importantly, to the extent provided in such agreement). The debtor licensor cannot interfere with the license rights granted therein. If the debtor licensor rejects the intellectual property contract, the licensee can either (1) treat the contract as terminated by such rejection and assert a claim for damages or (2) retain its rights under such contract for the duration of the contract, including any extension rights, provided the licensee pays its obligations thereunder. To be clear, if the licensee elects to retain its rights then the licensee retains the right to the continued use of the intellectual property as it existed at the time of the filing of the bankruptcy case for the duration of the license agreement, but the debtor licensor is not required take affirmative actions under the applicable intellectual property executory contract (save for the covenant not to sue the licensee for infringement and violations of the license's exclusivity provisions), such as providing maintenance, technology updates and upgrades, consultation, help or other services, nor will the debtor licensor be required to defend the licensee against infringement actions. In addition, if the licensee elects to retain its rights then the debtor must provide the licensee with any intellectual property held by the property **to the extent provided in the contract**.

PROACTIVE STEPS TO INSTITUTE NOW TO PROTECT IP POSITION DURING BANKRUPTCY

From the perspective of both the licensee and licensor, the language of the underlying contract is of the utmost importance in understanding the impact and treatment of a particular intellectual property contract in a U.S. bankruptcy case. As such, it is imperative, whether licensor or licensee, to review, understand and analyze the rights thereunder and to utilize any pre-bankruptcy filing discussions with contract counterparties to clarify, supplement and amend such

language as may be necessary in particular situations based on the facts and circumstances. Many commercial and technology transaction agreements, including software agreements, may have been negotiated at a time when both companies were solvent and bankruptcy was not a large or looming issue or negotiated by a team outside the legal department or without legal representation or agreements that are standard "form" agreements accepted throughout the industry. Whatever the nature, the following proactive steps can help protect a party's IP position should bankruptcy arise:

1. Inventory key agreements that contain IP Rights being licensed into or from company. Review provisions including:
    a. Language generally to determine whether executory or non-executory;
    b. Term and renewal provisions;
    c. Disincentive language for a rejection of the agreement or other obligations;
    d. Enforcement of IP Rights post-bankruptcy filing;
    e. Assignment provisions;
    f. Triggers for termination and whether there are any acceleration clauses;
    g. Contractual provisions regarding provision of, and rights to, underlying intellectual property;
    h. Improvement turnover timelines; and
    i. Structure of payment of the licensee fees, maintenance fees and royalty obligations.
2. Consider re-negotiating key terms that could affect the company if bankruptcy would ensue, including the expansion of rights to underlying intellectual property and potential for escrow arrangements.
3. Consider the ability to obtain a security interest in IP Rights or otherwise purchase same (which would involve an analysis of associated risks given timing and particular factual situation).

OUR TEAM

King & Spalding's Corporate, Finance and Investment Group and Intellectual Property Group and have extensive experience managing issues related to IP Rights facing businesses during bankruptcy events, along with evaluating and negotiating IP Rights in commercial agreements and technology transaction agreements. Our team includes well-respected partners, counselors, and associates that work together to handle the complex issues arising from bankruptcy that effect IP Rights. We have the practical perspective to help our clients understand the consequences of current events and strategic considerations on a case-by-case basis.

ABOUT KING & SPALDING

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[1] Although trademarks are specifically exempted from Bankruptcy Code Section 365(n), the Supreme Court, in *Mission Prod. Holdings, Inc. v. Tempnology, LLC*, __ U.S. __, 139 S. Ct. 1652, 1662–63 (2019) made clear that termination of a trademark agreement constituted breach, not termination or rescission, of that agreement and had the same consequence as a contract breach outside of bankruptcy, giving the counterparty a claim for damages, while leaving intact the rights the counterparty received thereunder.