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The Good, the Bad and the Ugly: Recent Canadian Bankruptcy Legislation Amendments and Their Impact on Intellectual Property Licensing

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The *Bankruptcy and Insolvency Act* (BIA) and *Companies' Creditors Arrangement Act* (CCAA) were recently amended. One of the amendments provides IP licensees with more certainty regarding the fate of their licenses when licensors restructure. While that amendment is a positive development for licensees, it also creates other significant uncertainties.

Background

The BIA and CCAA permit financially troubled debtors to continue operations while restructuring and making deals with creditors to service their debts. The CCAA applies only to companies with more than $5 million in debt. The BIA and CCAA respectively require a debtor to prepare a proposal or plan of arrangement specifying how the debtor intends to pay off its debts. Before the amendments, both acts allowed debtors to "disclaim" (i.e. terminate) contracts such as licenses as part of the restructuring, the logic being that debtors should be able to shed contracts that obstruct viable restructuring.

Before the amendments came into effect on September 18, 2009, if a license was disclaimed, the licensee no longer had permission to use the IP covered by the license. A licensee's only remedy was to file a claim seeking damages suffered due to the license's termination. Practically, the licensee usually had little chance of recovery, since typically the licensor had secured creditors whose claims would take priority and deplete the licensor's assets, if any.

The Good: The Amendments

The BIA and CCAA amendments still permit disclaimers of all contracts in a restructuring, including licenses. However, a licensor's ability to disclaim a license is now restricted by BIA subs. 65.11(7) and CCAA subs. 32(6). The BIA provision reads:

> If the debtor has granted a right to use intellectual property to a party to an agreement, the disclaimer or resiliation does not affect the party's right to use the intellectual property – including the party's right to enforce an exclusive use – during the term of the agreement, including any period for which the party extends the agreement as of right, so long as the party continues to perform its obligations under the agreement in relation to the use of the intellectual property.

The CCAA provision reads the same, except the word "debtor" is replaced by "company".

Because of the amendments, a licensor's disclaimer of a license will not affect the licensee's right to use the IP so long as the licensee continues to meet its obligations under the license (e.g. royalty payments). The license continues for the duration of the agreement and any extensions/renewals specified in the agreement. Licensees can also enforce any exclusivity provisions in the license agreement. The provisions only apply in a restructuring, not bankruptcies or receiverships where the common law applies.

The Bad: The Uncertainties

While the BIA and CCAA amendments improve the position of licensees, they also create ambiguities, including:

1. **What IP is captured by the amendments?** Neither the BIA or CCAA define intellectual property. Thus, it is unclear what types of IP are captured by the amendments, and whether the amendments apply only to registered IP rights or include unregistered rights.

2. **What is the meaning of "use"?** It is unclear whether rights ancillary to the right to use the licensed IP are captured by the term "use".

3. **Can the licensor disclaim other obligations?** The amendments are silent on whether licensors can disclaim other obligations such as enforcing or maintaining IP, indemnities, quality control provisions in trade-mark licenses, and tech support services in software license agreements.

4. **What exactly are the licensee's continuing obligations?** It is uncertain what a licensee's obligations are if the obligations depend on the debtor's actions and the debtor has disclaimed its obligations to perform those actions. E.g. if a software licensor disclaims technical support, maintenance and upgrade obligations, and the license does not apportion the royalty between the license to use the software and the fees for technical support, maintenance and upgrades, can the licensee pay a reduced royalty and still use the IP? The answer is no based on the amendments' wording, but a court may interpret the amendments differently.

5. **Can a court sell the IP to a third party free and clear of the license?** The relevant BIA and CCAA provisions do not preclude or prohibit sale of the licensed IP. It therefore appears that the IP subject to the disclaimed license could be sold to a third party, despite the licensee's ability to use the licensed IP under the BIA and CCAA amendments.

Unless the BIA and CCAA are amended to address the foregoing questions, it will be up to the courts to decide the answers.

The Ugly: When It May Not Make Sense to Continue a License

In some circumstances, it may be impractical for a licensee to continue a license beyond an interim period where the licensee transitions to a new licensor. Those scenarios include:

1. Software licenses, where the licensor has disclaimed its obligation to provide any support, maintenance or upgrades and the license agreement does not split the royalty between the fee for using the software vs. support, maintenance and upgrades. If the licensee decides to pay a reduced royalty to reflect the lack of technical support, it would breach its obligations under the license and not be entitled to use the software under the BIA and CCAA provisions. If the licensee does pay the royalty, the licensee is arguably overpaying due to the lack of tech support that may be required for the software's continued function and operation.

2. The licensor fails to maintain any relevant registrations and value. As in (1) immediately above, the licensor could very well be paying too high a royalty for the IP. As in (1) above and based on the amendments' wording, the licensee's unilateral reduction of the royalty would terminate the license.

3. The licensor disclaims quality control provisions in a trade-mark license. The exercise of such control is necessary to ensure distinctiveness.

4. The sale of the IP to a third-party purchaser. Given that a license is often considered a personal right granted by the licensor, the purchaser could claim that it does not have to honour the license in the absence of an agreement to do so. The result? The licensee will lose the right to use the IP.

What Can Licensees Do to Protect Themselves?

While the BIA and CCAA amendments are an improvement for licensees, licensees still face significant uncertainties and risks if a licensor restructures. Consequently, licenses should address the potential consequences of the licensor's insolvency. Ideally, licensees should attempt to protect themselves by negotiating contractual provisions that address possible scenarios if the licensor restructures (e.g. apportioning royalties between IP and technical support in software licenses, upfront payment of maintenance fees for patents and registration fees for trade-marks) or by participating as a shareholder in a bankruptcy remote entity (BRE), a subsidiary of the licensor whose sole purpose is to own and license IP. BREs are structured to minimize insolvency and thus the risk that the license will be disclaimed.

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