• BEYOND LEGISLATIVE REFORM: INTELLECTUAL PROPERTY LICENCES UNDER CANADIAN BANKRUPTCY LAW •

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Until the recent Canadian legislative reform of bankruptcy law, there was a lack of clarity in Canadian law with respect to the treatment of intellectual property ("IP") licences under the *Companies Creditors' Arrangement Act* ("*CCAA*") and the *Bankruptcy and Insolvency Act*, ("*BIA*"), specifically whether such licences could be disclaimed by companies restructuring under the statutes. Considering how widespread IP licences have become and their ever-increasing commercial importance, the uncertainty has resulted in complication and unpredictability, both of which are bad for business and the law, alike.

As will be discussed in greater detail below, Canadian legislative reform, in part inspired by earlier developments under United States bankruptcy law, will go a long way toward achieving more predictable legal results, but questions regarding the judicial interpretation of this reform remain. Canadian case law on the subject, including the recent decision of Justice Campbell of the Ontario Superior Court of Justice in *Destinator*, is instructive of pre-reform judicial thinking, and may provide an indication of how the new *CCAA* and *BIA* provisions will be interpreted and applied going forward.

LUBRIZOL AND U.S. BANKRUPTCY LAW REFORM

The catalyst for IP licence-related reform of the *U.S. Bankruptcy Code* (the "*Bankruptcy Code*") is widely acknowledged to be the case of *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*,[1] in which Richmond Metal Finishers, Inc. ("RMF") entered into a non-exclusive licence agreement with Lubrizol Enterprises Inc. ("Lubrizol"), giving Lubrizol use of a metal coating process technology owned by RMF (the "Licence"). Lubrizol's business was entirely dependent on the Licence, but before Lubrizol could make use of the Licence, RMF filed for bankruptcy and resolved to sell the technology to a third party. In order to better facilitate the sale, RMF sought to reject the Licence and forego any contractual obligations owed to Lubrizol thereunder. Despite the importance of the Licence to Lubrizol, the U.S. Fourth Circuit Court of Appeal (the "U.S. Court") permitted the trustee in the case to reject the Licence. The U.S. Court's decision was immediately criticized for the commercial uncertainty it created for IP licensees.

In order to prevent similar results, the U.S. Congress amended the *Bankruptcy Code* in 1988 to provide the following:

> Para. 365. Executory contracts and unexpired leases
> (…)
> (n)(1) If the trustee rejects an executory contract under which the debtor is a licensor of a right to intellectual property, the licensee under such contract may elect —
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> (A) to treat such contract as terminated by such rejection if such rejection by the trustee amounts to such a breach as would entitle the licensee to treat such contract as terminated by virtue of its own terms, applicable nonbankruptcy law, or an agreement made by the licensee with another entity; or
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> (B) to retain its rights (including a right to enforce any exclusivity provision of such contract, but excluding any other right under applicable nonbankruptcy law to specific performance of such contract) under such contract and under any agreement supplementary to such contract, to such intellectual property (including any embodiment of such intellectual property to the extent protected by applicable nonbankruptcy law), as such rights existed immediately before the case commenced, for —
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> (i) the duration of such contract; and
> (ii) any period for which such contract may be extended by the licensee as of right under applicable nonbankruptcy law.
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> (2) If the licensee elects to retain its rights, as described in paragraph (1)(B) of this subsection, under such contract —
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> (A) the trustee shall allow the licensee to exercise such rights;
>
> (B) the licensee shall make all royalty payments due under such contract for the duration of such contract and for any period described in para-

> graph (1)(B) of this subsection for which the licensee extends such contract; and
> (C) the licensee shall be deemed to waive —
> (i) any right of setoff it may have with respect to such contract under this title or applicable nonbankruptcy law; and
> (ii) any claim allowable under section 503(b) of this title arising from the performance of such contract.[2]

The *Bankruptcy Code* seeks to achieve a result in which the prejudice suffered by licensee and licensor is fairly balanced. Therefore, upon the rejection of an IP licence, the licensee may either: (1) pursue its claim for damages as an unsecured creditor under the *Bankruptcy Code*; or (2) retain its rights and obligations under the licence, including payment of any royalties or licence payments due thereunder, but without the benefit of right of setoff, if applicable. In order to further refine the balance of the parties' rights, the licensee may retain any right to exclusivity granted in the licence, but may not otherwise obtain specific performance of such contract. The section also limits the licensee's rights to those that existed prior to the commencement of the bankruptcy case, meaning that the licensee does not have a right to any maintenance of or upgrades to the IP post-bankruptcy filing.

CANADIAN CASE LAW: FROM *ERIN FEATURES* TO *DESTINATOR*

Recent Canadian legislative reform will alter the legal landscape, but it is instructive to review the development of the Canadian common law in this area for insight into pre-reform judicial thinking, which largely focused on whether IP licence agreements were proprietary or executory in nature, in the absence of explicit statutory guidance.

In *Re Erin Features No. 1 Ltd.*,[3] the trustee in bankruptcy sought to disclaim an agreement in which the bankrupt Erin Features had granted Modern Cinema Marketing Ltd. exclusive marketing rights in Canada to a film. The B.C. Supreme Court held the following:

> Assuming without deciding that a trustee in bankruptcy generally possesses a power to disclaim, I hold that the contract in issue here does not fall within the category of executory contracts which may be the subject to disclaimer.[4]

The Court reached this decision on the grounds that exclusive marketing rights convey a property interest that cannot be reversed. This is inconsistent with the principle that a licence does not transfer a property interest. Accordingly, this decision has been criticized by commentators.[5]

In *Re T. Eaton Co.*,[6] the Ontario Superior Court permitted T. Eaton Company Limited ("Eaton's") to disclaim an agreement under the *CCAA* with National Retail Credit Services Company ("NRCS"), which granted NRCS an exclusive licence to supply credit card services to Eaton's customers and to use its trademarks. When Eaton's sought to disclaim the agreement in the course of its restructuring, NRCS applied to the court for specific performance. In denying the application of NRCS for specific performance, Justice Farley held that to generally restrict debtor companies from repudiating contracts would constitute an insurmountable obstacle to effecting compromises and reorganizations and, accordingly, NRCS was entitled only to a claim for damages.[7] Justice Farley further held that the licences granted did not transfer any property interest to NRCS.[8]

In the 2008 case of *Royal Bank of Canada v. Body Blue Inc.*,[9] which was a receivership proceeding under the *BIA*, Body Blue had granted an exclusive licence to Herbal Care, a consumer health products company, to manufacture and sell paraben glycol free technology. The Ontario Superior Court of Justice held that a receiver was permitted to sell Body Blue's assets to a third party consumer health products company, including the technology licensed to Herbal Care, free and clear of any and all claims and liens.[10] Justice Morawetz held that the licence was a contractual right, as opposed to a property right, and the licensee only had an unsecured claim for damages.[11] It should be noted that Herbal Care did not, at any time, take any steps to set aside, vary or appeal the Approval and Vesting Order itself.

In the 2008 case of *Destinator*,[12] Destinator Technologies Inc. ("Destinator") had granted a navigation software licence to Zeta Software Technologies Ltd. ("Zeta"). The Ontario Superior Court of Justice held that Destinator was permitted to repudiate its licence agreement with Zeta during the *CCAA* proceeding, and to transfer the navigation software that was the subject of the licence to Intrinsyc Software International Inc., the purchaser of Destinator's assets, free and clear of any other interests, including any interest of Zeta in the navigation software. Justice Campbell held the following:

> Pursuant to the [asset purchase agreement], the Navigation Software was transferred to Intrinsyc, pursuant to the Approval and Vesting Order. This Court holds that it has the jurisdiction to effect such a transfer free and clear of any other interests, and this is the effect of the Approval and Vesting Order. The effect is to extinguish any interest Zeta may have had in the Navigation Software, be it through the Licensing Agreement or otherwise, subject to any challenge Zeta may be entitled to make in this Court.[13]

It should be noted that Zeta, an Israeli company, decided not to participate in the *CCAA* proceeding, but rather challenged the termination of its licence in the courts in Israel.

In the absence of legislative guidance in the *CCAA* and *BIA* on the subject of IP licence terminations, Canadian jurisprudence had developed to largely resemble pre-*Lubrizol* U.S. jurisprudence. In balancing the interests of licensees and restructuring licensors, Canadian courts have exhibited a clear preference to supporting the licensors' restructuring efforts, including the rights of termination, and a willingness to vest assets in third party purchasers free and clear of the interests of licensees. As a result, licensees were faced with a situation where the enforceability of their IP licences were, for all intents and purposes, subject to potential termination by insolvent licensors, regardless of the degree to which such licences were critical to the licensees' business.

CANADIAN LEGISLATIVE REFORM

In 2005, the Canadian Parliament passed a comprehensive package of reforms to Canadian insolvency and restructuring laws, including the *CCAA* and *BIA* (the "*2005 Amendments*"). The *2005 Amendments* were designed to respond to the recommendations of the Senate Standing Committee on Banking, Trade and Commerce, which had previously conducted a series of hearings on potential amendments to bankruptcy legislation.

The *2005 Amendments* were not immediately proclaimed in force, and extensive amendments to the *2005 Amendments* were enacted in 2007 in order to further refine the legislative reforms. The entirety of the combined reform package (the "Canadian Legislative Reform") was only proclaimed in force effective September 18, 2009.

As previously mentioned, the Canadian Legislative Reform included amendments concerning the disclaimer of IP licences. The *CCAA* (s. 32(6)) and *BIA* (s. 65.11(7)) were amended to include the following provision:

> Intellectual property
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> If the company 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, as long as the party continues to perform its obligations under the agreement in relation to the use of the intellectual property.[14]

This amendment to the *CCAA* and *BIA* will protect the use of licensed IP by a licensee, notwithstanding the restructuring of the licensor. Assuming the licensee's continued fulfillment of its obligations under the licence, the licensor will not be permitted to disclaim the licence in proceedings under the *CCAA* or a proposal under the *BIA*. Importantly, unlike under the *Bankruptcy Code*, there is no statutory framework for balancing the resulting prejudice to the licensee and restructuring licensor. Also, there is no mechanism for courts to weigh the resulting prejudice to the licensee and licensor of permitting the licensee to continue to use the IP, notwithstanding the licensor's bankruptcy. In this respect, the protection afforded to licensees is nearly absolute, subject to any limitations which courts may read into the provisions.

BEYOND CANADIAN LEGISLATIVE REFORM

However, despite the Canadian Legislative Reform, some uncertainty remains. With respect to the *BIA*, it appears that the new provision is only relevant to debtor licensors in respect of whom either a notice of intention or a proposal was filed, as opposed to debtor licensors in bankruptcy or receivership proceedings. To exclude licensees of IP impacted by a debtor licensor's receivership or bankruptcy proceeding under the *BIA* from the protections afforded by

s. 65.11(7) appears to be at odds with the intent of the Canadian Legislative Reform.

The new provision refers to the licensee's "right to use" the relevant IP. The rights that accompany an IP licence typically include more than just the narrow use of the IP, such as the right to receive upgrades and maintenance and to modify and copy the IP. It remains to be seen how expansively the licensee's "right to use" the IP will be interpreted by courts. Perhaps courts will choose to weigh the prejudices to the licensee and licensor in their interpretation of this term.

In addition, the orders in *Body Blue* and *Destinator* each vested the technology that was subject to the relevant licence in third party purchasers. Although permitting the vesting of technology in third parties free of any licensee interests would seemingly thwart the purpose of the Canadian Legislative Reform, the new provisions are silent with respect to the rights of the licensee in such a situation. Courts may also choose to weigh the prejudices to the licensee and licensor in determining the parties' respective rights in this regard.

There is no question that the level of uncertainty and exposure faced by licensees has been dialed down considerably by the legislative reform. No longer will the specter of a licensor's bankruptcy threaten the ability of the licensee to carry on business, where that licensee is dependent on the continued use of the licence in its own business.

Nevertheless, the courts' interpretations of the new provision will be eagerly awaited, and while there is no statutory mechanism for courts to weigh prejudice to the licensee and licensor with respect to the disclaimer of a licence, these considerations will likely weigh heavily in the development of the law around the related issues outlined above.

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1 756 F. (2d) 1043 (Fourth Cir. 1985), cert. denied, 475 U.S.C. 1057 (1986).

2 11 USC 365(n).

3 [1991] B.C.J. No. 3330, 8 C.B.R. (3d) 205 (B.C.S.C.) ("*Erin Features*").

4 *Supra* note 3, at para. 3.

5 Gabor G.S. Takach and Ellen L. Hayes, "Case Comment, *Re Erin Features #1 Ltd.*" (1993), 15 C.B.R. (3d) 66.

6 [1999] O.J. No. 4216, 14 C.B.R. (4th) 288 (Ont. S.C.) ("*Eaton's*").

7 *Supra* note 6, at paras. 7 and 15.

8 *Supra* note 6, at para. 11.

9 [2008] O.J. No. 1628, 42 C.B.R. (5th) 125 (Ont. S.C.) ("*Body Blue*").

10 *Supra* note 9, at para. 24.

11 *Supra* note 9, at para. 21.

12 *Destinator* (reasons for decision released June 26, 2009), Toronto (Commercial List) Court File No. CV-08-CL-007483-0000 (Ont. S.C.) ("*Destinator*").

13 *Supra* note 12, at para. 39.

14 *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36 at s. 32(6) and *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3 at s. 65.11(7) (although reference is made to the "debtor" in place of the "company" in the *BIA*).