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The Protection of Intellectual Property Licenses in Insolvency: Lessons from the Nortel Case

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**THE PROTECTION OF INTELLECTUAL
PROPERTY LICENSES IN INSOLVENCY:
LESSONS FROM THE *NORTEL* CASE**

*Anthony Duggan and Norman Siebrasse**

INTRODUCTION

Intellectual property-based industries have become an increasingly vital part of the economy, but firms in these industries are not immune from economic distress. Prominent Canadian illustrations include the *Nortel* proceedings and Blackberry's recent financial woes. Nortel filed for protection under Canada's Companies' Creditors Arrangement Act¹ (CCAA) in January 2009. At the same time, various Nortel affiliates commenced parallel proceedings under Chapter 11 of the U.S. Bankruptcy Code² and the Insolvency Act 1986 (U.K.). In *Re Nortel Networks Corp.*, the Canadian court approved Nortel's application to sell its assets in a series of going concern business sales. The assets included a substantial patent portfolio, and many of the patents were subject to current licensing agreements. Nortel developed an elaborate strategy to ensure as far as possible that licensees' interests

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¹ Canada's Companies' Creditors Arrangement Act (CCAA), R.S.C., 1985, c. C-36.

² 11 U.S.C. (2014).

would not be affected by the sale of the patents, but the broader question raised by the case was whether a transferee of intellectual property acquires title subject to, or free of, outstanding licenses. If those licenses are not enforceable against a transferee, the licensee may find itself in the unenviable position of having to re-license rights which it had already paid for, after having invested substantial sunk costs in reliance on those rights. The question can arise whether the sale takes place in the course of insolvency proceedings (as with Nortel) or whether it takes place outside the insolvency system (as Blackberry had been planning).

In principle the answer to this question should be the same in both contexts; otherwise outcomes may vary arbitrarily depending on the circumstances of the sale, which in turn may skew the choice between selling inside or outside the insolvency system. In other words, the priority rules that apply in insolvency proceedings should mirror the rules that apply outside insolvency. There are two main problems in this connection. The first is that in Canada the priority rules governing competing claims to intellectual property outside insolvency are remarkably unsettled. The second is that while the Canadian insolvency laws permit a debtor to sell its assets outside the ordinary course of business, subject to court approval, they do not specifically import the priority rules that apply outside insolvency proceedings to determine the purchaser's rights relative to those of third party claimants.

In both respects, the Canadian and United States positions are very different. By and large, the law outside bankruptcy in the United States is that a transferee of intellectual property is bound by prior licenses. This rule is imported into bankruptcy by section 363(f) of the U.S. Bankruptcy Code, which provides that, in the case of an asset sale, the purchaser acquires title free and clear of competing interests "if . . . applicable nonbankruptcy law permits sale of such property free and clear of such interest."³ The concern U.S. laws address is that the licensee may have made substantial investments in reliance on the license, which would be lost if the license was subordinate to third party claims. The potential damage to its reliance interest would increase the upfront risk to prospective licensees, which in turn would

³ 11 U.S.C. § 363 (2014).

have a chilling effect on the licensing of intellectual property. This policy is also reflected in section 365(n) of the U.S. Bankruptcy Code which, in general terms, limits the right of an intellectual property owner in bankruptcy to reject (disclaim) license agreements.⁴ There is a similar restriction in the Canadian insolvency law provisions governing disclaimer of agreements,⁵ suggesting that the importance of protecting the intellectual property licensee's reliance interest has been recognized in Canada too. The problem in Canada is that this policy has not been carried over into the asset sale context.

The purpose of this article is to compare and contrast the protection given to intellectual property licensees in Canada and the United States, using the *Nortel* case as the focus for the discussion. Part I expands on the underlying policy considerations. The strategy Nortel developed for addressing licensees' interests revolved around section 365(n) of the U.S. Bankruptcy Code. In Part II, we provide a fuller account of section 365 at large and section 365(n) in particular, and of the corresponding Canadian provisions. We discuss the *Nortel* case in Part III. In Part IV, we turn to the rules governing asset sales in both countries, making the point that in Canada, as the law currently stands, while a debtor may be effectively precluded from disclaiming intellectual property licenses in insolvency proceedings, it might nevertheless be able to achieve the same result by selling the underlying intellectual property. This possibility did not surface in the *Nortel* case itself, because the sale process in *Nortel* was largely driven by United States, not Canadian, law; but it is likely that in some future case the issue will arise. In Part V, we discuss possible reforms. We conclude that reform of Canadian law relating to the rights of licensees on assignment of the licensed rights is urgently required, both outside and inside of insolvency.

I. THE POLICY CONSIDERATIONS

Protection against termination of licenses as a result of the licensor's financial distress has become a pressing concern with the rise of "patent assertion entities," pejoratively referred to as "patent trolls," whose business model consists of buying and asserting patents against

⁴ 11 U.S.C. § 365 (2014) (discussed *infra* Part II, Section A).

⁵ See, e.g., CCAA, R.S.C., 1985, c. C-36; see *infra* Part II, Section B.

other firms without exploiting the technology themselves.⁶ The \$612.5 million settlement entered into by Research in Motion in consequence of its litigation with the patent assertion entity NTP is the best known example of trolling involving a Canadian firm, but any firm doing business in the United States is exposed.⁷ At present, trolls are most active in the United States, but at least one patent assertion entity is already active in Canada, and there is concern that trolling will spread further in Canada and other jurisdictions as the business model matures.⁸

There are two broad types of trolling behavior.⁹ One is litigation of poor quality patents to obtain litigation cost settlements, in which the defendant finds it cheaper to settle than to challenge the validity of the patent in court.¹⁰ The more problematic variety involves opportunistic litigation, which takes advantage of the defendant's investment in the technology at issue.¹¹ The well-known *NTP v. Research in Motion, Ltd.* litigation is a classic example.¹² *NTP* held broad patents covering the use of cell phone frequencies for email access.¹³ While this idea itself was no doubt valuable, there is no question that the large investment made by RIM (Research in Motion) in implementing the concept also made a major contribution to the success of the company; indeed, it is not unlikely that RIM's contribution very substantially exceeded the value of the idea itself. However, RIM did not obtain a license from NTP at the outset, apparently because it developed the concept independently and it was not aware of the patent at the time of its investment.¹⁴ Independent creation is not a defense to patent infringement however, and as a

⁶ See generally Norman Siebrasse, *Business Method Patents and Patent Trolls*, 54 CAN. BUS. L.J. 38 (2013).

⁷ See *NTP, Inc. v. Research in Motion, Ltd.* (Fed. Cir. 2005); and see *Coastal Contacts Inc. v. Elastic Path Software Inc.* (2013) B.C.S.C. 133 (Can.) for an example of a smaller Canadian firm caught by a U.S. troll.

⁸ Dovden Investments Ltd. has filed approximately one third of patent infringement actions in Canada in 2013. See Alan Macek, *Patent Trolls in Canada?*, SLAW (June 21, 2013), www.slaw.ca/2013/06/21/patent-trolls-in-canada/.

⁹ See generally Norman Siebrasse, *supra* note 6.

¹⁰ *Id.* at 42.

¹¹ *Id.*

¹² See *NTP*, 418 F.3d 1282.

¹³ See *id.*

¹⁴ *Id.*

patent is a property right, injunctive relief is normally granted to a successful patentee.¹⁵ After succeeding in its U.S. infringement action against RIM, NTP was awarded \$53.7 million in damages, but armed with a permanent injunction, it was able to extract a settlement of over \$600 million.¹⁶ This illustrates the general problem of opportunism; if bargaining between the parties takes place after the user of the patented technology has invested sunk costs in reliance on that technology, the amount which the owner of the patent can extract is not merely the value of the technology, but also the value of that additional investment, which would have to be abandoned if no settlement can be reached. The higher price that can be extracted because of sunk costs is known as the “hold-up” value of the patent, and correspondingly, the problem is commonly known as “patent hold-up.” To use a simple analogy, if you are going to buy land to build your retirement home, you want to negotiate the price with the landowner before you build your house, not afterwards.

The potential for opportunism arises in patent cases because independent creation is not a defense, and patent rights are often poorly defined, so it may be difficult for a technology user to know in advance whether it is infringing any patent rights. The problem of patent trolls appears to be greatest with respect to software patents and business methods patents, both of which are said to be particularly poorly defined.¹⁷ More generally, however, the problem of opportunism arises whenever the user of technology has to bargain after investing sunk costs in reliance on that technology.¹⁸ This is pervasive in the case of licensees. It is normal for a business user of almost any technology to invest in its implementation. Even basic office productivity software requires training staff in its use, and any more specialized technology requires commensurately more specific investment. Licensees, by definition, protect themselves against opportunism by licensing the technology on reasonable terms before investing in it. But the opportunism will be a threat if the license is terminated, even though the licensee is living up to its terms and wants

¹⁵ This has changed in the United States since the decision of the U.S. Supreme Court in *eBay Inc. v. MercExchange, L.L.C.*, 547 U.S. 388 (2006), which held that injunctions should no longer be granted routinely to prevailing patentees.

¹⁶ NTP, 418 F.3d at 1287, 1325-26.

¹⁷ Siebrasse, *supra* note 6 at 47.

¹⁸ *Id.* at 42-43.

to continue using the technology. This is exactly the problem that arises if the license can be terminated on insolvency of the licensor, or if a licensor can effectively terminate the license simply by assigning the intellectual property rights to a third party. Opportunism of this type can arise with respect to trademarks or copyright just as well as with patents, because it does not depend on features of the intellectual property peculiar to patents.

The problem is illustrated by the recent *Qimonda* decision in the United States.¹⁹ A major German semiconductor manufacturer, Qimonda, became insolvent, and the insolvency administrator sent letters to the licensees of Qimonda's patents declaring that their licenses were unenforceable under the German Insolvency Code.²⁰ The insolvency administrator intended to re-license the patents back to the existing licensees for the benefit of Qimonda's creditors.²¹ That is, the existing licensees would have had to pay again for licenses that they already had. Moreover, the licensees were apparently largely other semiconductor manufacturers who would have had to negotiate the licenses in the face of very large sunk costs invested in their semiconductor designs in reliance on the licensed technology, and the re-negotiated licenses would have been substantially more expensive than the original licenses.²²

The United States litigation arose because the insolvency administrator appointed by the Munich court sought an order from the U.S. courts recognizing the German proceeding in order to obtain administration of Qimonda's U.S. patents. The U.S. courts ultimately granted the order, but subject to the condition that licensees of Qimonda's U.S. patents be given the same treatment that they would have received under the U.S. Bankruptcy Code, which, as described below, provides substantial protection to existing licensees.

¹⁹ *Jaffé v. Samsung Elecs. Co.*, 737 F.3d 14 (4th Cir. 2013) (known as *Qimonda* after the name of the debtor, for which Jaffé was the insolvency administrator) [hereinafter *Qimoda*].

²⁰ *Insolvenzordnung* [InsO] [German Insolvency Code], Oct. 5, 1994, BUNDESGESETZBLATT [BGBl.] 2082.

²¹ *Qimonda*, 737 F.3d 14.

²² *Id.* (The original licenses were largely paid for in-kind with cross-licenses, which is common practice in the semi-conductor industry.).

Qimonda illustrates the threat to the licensee's reliance interest, which may emerge from unilateral termination of licenses as a result of insolvency. We will see that the recent amendments to the Canadian insolvency laws provide some protection to licensees from termination by the insolvency administrator, as in *Qimonda*, but that protection can potentially be circumvented by termination of the rights on an assignment of the technology by the insolvency administration, rather than disclaimer of the license by the insolvency administrator itself. This is a major concern because patent trolls often obtain their patents on the insolvency of a technology company. This means that if *Qimonda* were to arise in Canada, the licensees might have to re-negotiate their licenses from trolls who had purchased the patent rights from the insolvency administrator. Moreover, the rights of a licensee outside of bankruptcy are unclear; remarkably it may well be that license rights are unenforceable against an assignee. This means that an intellectual property owner in financial distress might be able to monetize its rights by assigning them to a troll prior to any insolvency, and the troll would be able to re-negotiate with the licensee free of the licenses, which bound the original owner.

II. The Rejection (Disclaimer) of Executory Contracts

A. The United States' Position

Section 365 of the U.S. Bankruptcy Code provides for the rejection, assumption, and assignment of executory contracts in bankruptcy proceedings.²³ All three options require court approval, and the courts generally apply a business judgment test in determining whether to grant approval.²⁴ The purpose of the provisions is to maximize the value of the bankruptcy estate for the benefit of the creditors by allowing the trustee to cherry-pick the debtor's uncompleted contracts, rejecting contracts that would be unprofitable for the estate to perform and assuming contracts where the returns to the estate from performance are likely to exceed the cost. The Bankruptcy Code does not define "executory contract," but the term is generally accepted to mean "a contract under which the obligation[s] of both the bankrupt and the other party to the contract are so far

²³ 11 U.S.C. § 365 (2014).

²⁴ The provision imposes various other restrictions on assumption and assignment, which are not presently relevant.

unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other” (the “Countryman definition”).²⁵ The key feature of the Countryman definition is that to qualify as an executory contract, an agreement must remain at least partially unperformed *on both sides*.

Some intellectual property license agreements may fall outside the scope of the provision for this reason. The outright sale of a product coupled with a non-exclusive license to use the intellectual property embodied in the product is case in point. A particular example is where the debtor or counter-party distributes “a mass-marketed computer software product . . . in conjunction with a ‘shrink wrap’ end user license agreement granting the user nonexclusive rights to use the software.”²⁶ “The end user makes a one-time payment and receives the software product. . . . [T]he end user may have ongoing responsibilities under [the] license based on the restrictions in the license,” but the licensor’s performance is complete upon delivery of the product.²⁷ Another example is where an “author . . . licenses a completed copyrighted work to a publisher in exchange for either a lump sum payment or an ongoing royalty stream.”²⁸ Here the “licensor’s obligations are complete upon delivery of the work” and, since the contract is not still at least partially unperformed on both sides, section 365 of the U.S. Bankruptcy Code may not apply.²⁹

On the other hand, many intellectual property licenses do fall within the Countryman definition because there are outstanding obligations on both sides. For example, in the case of a patent license, the licensee will typically have “an ongoing obligation to . . . pay royalties for the life of the agreement” and may have “[o]ther material ongoing . . . obligations [as well,] such as sharing [the] technology with the licensor . . . and marking all products sold under the license with [the appropriate] patent notice.”³⁰ For its part, the licensor will

²⁵ Vern Countryman, *Executory Contracts in Bankruptcy: Part 1*, 57 MINN. L. REV. 439, 460 (1973).

²⁶ Peter S. Menell, *Bankruptcy Treatment of Intellectual Property Assets: An Economic Analysis*, 22 BERKELEY TECH. L.J. 733, 759 (2007).

²⁷ *Id.* at 766.

²⁸ *Id.* at 762.

²⁹ *Id.*

³⁰ *Id.* at 761.

commonly have ongoing obligations such as giving a “nonexclusive licensee notice of any patent infringement suit or any other use or licensing of the process, refraining from licensing the technology to anyone else at a lower royalty rate . . . , approving grants of sublicenses . . . , indemnifying licensees for losses, and defending claims of infringement.”³¹

Some courts in the United States have held that the licensor’s forbearance from suing the licensee for infringement is an ongoing obligation and that the license agreement is an executory contract on that basis, regardless of whether the licensor is subject to any other ongoing obligations.³² However, this view has been disputed on the ground that by granting the license, the licensor gives up the right to sue the licensee for infringement and the licensor’s performance is complete at that point.³³ A copyright license will satisfy the Countryman definition if it relates to a work yet to be created or that is still to be edited, revised, or otherwise adapted.³⁴ In such cases, the creative artist is subject to ongoing obligations and so the contract remains at least partly unperformed on her side, while the publisher’s obligation to publish the work represents an unperformed obligation on its side.³⁵ A trademark license will nearly always satisfy the Countryman definition because the licensor has continuing quality control obligations and the licensee typically has payment, reporting, marketing, and other continuing performance obligations.³⁶ Business-to-business software licensing agreements typically involve ongoing performance obligations on both sides and so satisfy the Countryman definition, but, as indicated above, business-to-consumer (end user)

³¹ *Id.* at 761-62; *see also* Peter M. Gilhuly, Kimberly A. Posin & Ted A. Dillman, *Intellectually Bankrupt?: The Comprehensive Guide to Navigating IP Issues in Chapter 11*, 21 AM. BANKR. INST. L. REV. 1, 2-10 (2013).

³² *See, e.g.*, *Everex Sys. v. Cadtrak Corp. (In re CFLC, Inc.)*, 89 F.3d 673 (9th Cir. 1996).

³³ *Id.*; *Cf.* Madlyn Gleich Primoff & Erica G. Weinberger, *E-Commerce and Dot-Com Bankruptcies: Assumption, Assignment and Rejection of Executory Contracts, Including Intellectual Property Agreements, and Related Issues Under Sections 365(c), 365(e) and 365(n) of the Bankruptcy Code*, 8 AM. BANKR. INST. L. REV. 307, 316.

³⁴ Menell, *supra* note 26 at 763.

³⁵ *Id.* at 763; Gilhuly et al., *supra* note 31, at 8-9.

³⁶ Menell, *supra* note 26 at 764; Gilhuly et al., *supra* note 31, at 9-10.

license agreements typically do not involve ongoing performance obligations on the licensor's part.³⁷

In *Lubrizol Enterprises v. Richmond Metal Finishers*, the U.S. Court of Appeals for the Fourth Circuit held that a technology license was an executory contract to which section 365 of the U.S. Bankruptcy Code applied, entitling the debtor-licensor's trustee to reject the agreement, subject to the court's approval.³⁸ The *Lubrizol* case was widely criticized on both doctrinal and policy grounds and, in 1988, Congress enacted section 365(n) to reverse the decision.³⁹ Section 365(n) provides that "[i]f the trustee rejects an executory contract under which the debtor is the licensor of a right to intellectual property, the licensee" may either: (1) treat the contract as terminated if the rejection would constitute a repudiatory breach outside bankruptcy; or (2) elect to retain its basic rights under the contract for the duration of the term, including the right to enforce any exclusivity provision, subject to a continuing obligation to make royalty payments.⁴⁰ If the licensee exercises the second option, it retains its right to the intellectual property itself, effectively limiting the trustee's rejection to ancillary aspects of the agreement (for example, obligations relating to the provision of training, maintenance, or update facilities).

B. The Position in Canada

Section 65.11 of the Bankruptcy and Insolvency Act (BIA), which applies in BIA proposal proceedings, and CCAA, section 32, which applies in CCAA proceedings, provide for the disclaimer or resiliation (rejection) of agreements.⁴¹ The provisions were enacted in

³⁷ Menell, *supra* note 26 at 765-66.

³⁸ See generally *Lubrizol Enters. v. Richmond Metal Finishers*, 756 F.2d 1043 (4th Cir. 1985).

³⁹ Jay Westbrook, *The Commission's Recommendations Concerning the Treatment of Bankruptcy Contracts* (1997) 5 AM. BANKR. INST. L. REV. 463, 470-72. See also *Sunbeam Prods. v. Chi. Am. Mfg.*, 686 F.3d 372 (7th Cir. 2012) (rejecting the *Lubrizol* reasoning); Jarrod N. Cone, *A "Sunbeam" of Hope: The Seventh Circuit's Solution Overcoming Disparaging Treatment to Trademark Licensees Under the Bankruptcy Code*, 20 J. INTEL. PROP. L. 347 (2013).

⁴⁰ 11 U.S.C. § 365(n) (2014).

⁴¹ Bankruptcy and Insolvency Act (BIA), R.S.C. 1985, c. B-3.

2005, amended in 2007, and came into force in 2009.⁴² The main features are:

- the trustee (monitor) must first approve the proposed disclaimer;
- following this, the debtor must notify the counter-party, and the counter-party has fifteen days to apply to the court for disallowance of the disclaimer;
- in hearing an application by either the counter-party or the debtor, the court must consider whether the disclaimer would enhance the prospects of a viable restructuring⁴³ and whether the disclaimer “would likely cause significant financial hardship to [the counter-party]”⁴⁴;
- if the contract is disclaimed, the counter-party has a provable claim in the proceedings for any loss; and
- the following contracts cannot be disclaimed: eligible financial contracts, collective agreements, a financing agreement where the debtor is the borrower and a lease of real or personal property where the debtor is the landlord (lessor).

The provisions refer to “agreements” and, unlike their United States counterpart, they are not limited to “executory contracts.”⁴⁵ It is beyond the scope of the present discussion to explore the implications

⁴² Statute c. 47, enacted in November 2005; Statute c. 36, enacted in June, 2007.

⁴³ “[W]ould enhance the prospects of a viable proposal being made in respect of the debtor”, BIA, R.S.C. 1985, s. 65.11; “would enhance the prospect of a viable compromise or arrangement being made in respect of the company”, CCAA, R.S.C., 1985, s. 32. This wording presupposes restructuring proceedings, as opposed to liquidation proceedings. But it has been held that the provision should be interpreted expansively to cover liquidation proceedings as well: *Re Timminco Ltd.*, [2012] ONSC 4471 (Can. Ont. S.C.J.), at ¶¶. 51,52.

⁴⁴ CCAA, R.S.C., 1985, s. 32.

⁴⁵ See David Ullmann & Melissa McCready, *Licensed to Steal: The Rights of IP Licensors and Licensees in an Insolvency*, ANN. REV. INSOLVENCY L. 201, 203 (2010).

of this point;⁴⁶ for present purposes, it is sufficient to note that the provisions clearly apply to intellectual property license agreements.

BIA section 65.11(7) and CCAA section 32(6) are loosely based on section 365(n) of the U.S. Bankruptcy Code. They provide that if the debtor has granted to a party to an agreement a right to use intellectual property, the disclaimer or resiliation does not affect the party's right to use the intellectual property during the term of the agreement, as long as the party continues to perform its obligations under the agreement in relation to the use of the intellectual property.⁴⁷

BIA section 65.11 applies in BIA proposal proceedings and CCAA section 32 applies in CCAA proceedings.⁴⁸ There is, inexplicably, no corresponding provision for disclaimer in bankruptcy proceedings. However, the courts have held that there is a common law power of disclaimer.⁴⁹ The common law power of disclaimer derives from the trustee's freedom not to perform the contract. Non-performance is a breach of contract which entitles the counter-party to the normal contract remedies. However, unless the counter-party has a right of specific performance or a similar right, the counter-party cannot compel the trustee to perform the contract and it will be limited to a damages claim for which it will have to prove in the debtor's bankruptcy.⁵⁰ In *Re Thomson Knitting Co.*, the court held that the trustee must elect to affirm or disclaim within a reasonable time and, failing an election, the counter-party is entitled to assume that the trustee has disclaimed the contract.⁵¹ BIA, section 121(1) defines "provable claim" to mean "debts and liabilities . . . to which the bankrupt is subject" on the date of the bankruptcy or "to which the bankrupt may become subject during" the bankruptcy by reason of an obligation incurred

⁴⁶ For discussion, see Anthony Duggan & Norman Siebrasse, *The Disclaimer, Affirmation and Assignment of Intellectual Property Licences in Insolvency*, J. INSOLVENCY INST. CAN. 163, 166-69.

⁴⁷ BIA, R.S.C. 1985, s. 65.11(7); CCAA, R.S.C., 1985 s. 32(6).

⁴⁸ BIA, R.S.C. 1985, s. 65.11(7); CCAA, R.S.C., 1985 s. 32(6).

⁴⁹ *Re Thomson Knitting Co.* (1924), 5 C.B.R. 189 (Can. Ont. S.C. in Bankruptcy)(aff'd (1925) 5 C.B.R. 489 (Can. Ont. S.C. in Bankruptcy App. Div.)); *New Skeena Forest Products v. Don Hull Sons Contracting* (2005), 251 D.L.R. 4th 328 (Can. B.C. C.A.); *In the Matter of the Bankruptcy of North American Steamships Ltd.* 2007 B.C.S.C. 267.

⁵⁰ *Id.*

⁵¹ See generally *Re Thomson Knitting Co.* (1924), 5 C.B.R. 189.

before the date of the bankruptcy.⁵² In other words, generally speaking, only pre-filing claims are provable claims. However, the counterparty's claim, which arises when the trustee disclaims a contract, is a provable claim even though it arises post-filing. This is an exception to the general rule.⁵³

It is unsettled whether the common law right of disclaimer extends to intellectual property licenses. In *Re Erin Features No. 1 Ltd.*, the court denied the right of a trustee in bankruptcy to disclaim a license agreement giving the licensee exclusive rights to market a film in Canada.⁵⁴ The decision was based on the proposition that the right of disclaimer cannot be used to disturb established property rights. On the other hand, in *Re T. Eaton Co.*, the court allowed the debtor in CCAA proceedings to disclaim an agreement giving a credit card company an exclusive license to supply credit card services to the debtor's customers.⁵⁵ The court decided the case mainly on the basis that restricting the debtor's right to disclaim unprofitable contracts

⁵² BIA, R.S.C. 1985, s. 121(1).

⁵³ The exception is provided for in BIA, R.S.C. 1985, s. 121(1), which provides as follows:

“All debts and liabilities, present or future, to which the bankrupt is subject on the da[te] on which the bankrupt becomes bankrupt or to which the bankrupt may become subject before the bankrupt's discharge by reason of any obligation incurred before the day on which the bankrupt becomes bankrupt shall be deemed to be claims provable in proceedings under this Act.” (Emphasis added).

Duncan explains the meaning of the italicized words as follows:

“The class of claims covered by [these words] include[s] cases of contract where the trustee either disclaims or ceases to perform the contract. In such case[s] the creditor may prove against the estate for the damages occasioned by the breach of the contract, and this is his only remedy.”

See Roderick J. Wood & David J. Bryan, *Creeping Statutory Obsolescence in Bankruptcy Law*, 3 J. INSOLVENCY INST. CAN. 1, 14-15 (2014) (citing LEWIS DUNCAN, THE LAW AND PRACTICE OF BANKRUPTCY IN CANADA 428-29 (Carswell ed., 1922).

⁵⁴ See generally *Re Erin Features No. 1, Ltd.* (1991), 8 C.B.R. 3d 205 (Can. B.C. S.C.).

⁵⁵ *Re T. Eaton Co.*, (1999) 14 C.B.R. 4th 288 (Can. Ont. S.C.J.).

would threaten the viability of restructuring arrangements.⁵⁶ But the court also held, relying on English authority and contrary to *Erin Features*, that a license does not confer property rights on the licensee. Therefore, there is no reason for treating the disclaimer of licenses any differently from contracts at large.⁵⁷

It may be a mistake to think of the issue in terms of property rights. Disclaimer of a contract in insolvency proceedings amounts to a breach of the contract, not rescission. The essence of a license agreement is that the licensor promises not to sue the licensee for infringement provided the licensee observes the terms of the license. Outside bankruptcy, if the licensor sued the licensee for infringement even though the licensee was in compliance with all its obligations under the license agreement, the licensor would be in breach of its primary obligation under the license agreement and the court would disallow the action. In principle, the position should be the same in bankruptcy, given that the rights of the trustee or debtor in bankruptcy are no larger than the debtor's rights outside bankruptcy. In other words, disclaimer of a license should not prevent the licensee from using the intellectual property: if the trustee or debtor sues the licensee for infringement, the court should disallow the action, just as it would have done if the action had been brought outside bankruptcy.

CCAA section 32 had been enacted but had not been brought into force at the time of the *Nortel* proceedings. It follows that at the time of the proceedings the right of a debtor to disclaim agreements in CCAA proceedings was governed by the common law as outlined above and at common law it was unclear whether a licensor could disclaim a license agreement.

III THE NORTEL CASE

In *Re Nortel Networks Corp.*,⁵⁸ the court approved Nortel's application to sell its assets, which included a substantial patent portfolio, in a series of going concern business sales. The proposed

⁵⁶ See generally *id.*

⁵⁷ See *Heap v. Hartley* (1889), 42 Ch.D. 461 (C.A.).

⁵⁸ *Re Nortel Networks Corp* (2009), 56 C.B.R. 5th 224 (Can. Ont. S.C.J. [Commercial List]).

patent sales were complicated by the fact that Nortel had entered into numerous license agreements respecting the patents and it did not have records for all of them. In other words, some of the patents were subject to licenses Nortel could not identify. To avoid potential disputes, which would have detracted from the value generated by the sales, Nortel decided that the patents would be sold subject to certain classes of licenses, including “known licenses” and “commercial licenses.” Known licenses were licenses of which Nortel was aware; commercial licenses were licenses Nortel had granted in the ordinary course of its business, including end-user licenses, whether or not they were specifically known to Nortel or the purchasers.

To deal with licensees whose rights would not be preserved by the terms of sale (the “unknown licensees”), Nortel devised a strategy based on section 365(n) of the U.S. Bankruptcy Code. As indicated above, section 365(n) provides that if the trustee rejects an executory contract, under which the debtor is an intellectual property licensor, the licensee has a choice either to: (1) treat the contract as terminated; or (2) elect to retain its basic rights under the contract for the duration of the term. The Nortel strategy gave unknown licensees this choice. Notices of the proposed sales were widely published, in newspaper advertisements and elsewhere, inviting unknown licensees to identify themselves and establish their claims by a specified date. The interests of licensees who responded in time would continue following the patent sales and all such licenses would be enforceable against the patent transferee. In effect, unknown licensees who came forward by the specified date would transform themselves into known licensees. On the other hand, unknown licensees who failed to identify themselves by the claims bar date would be deemed to have elected, under section 365(n), to have their contracts terminated.

It should be noted that there was no particular class of unknown licensees that were suspected to exist but could not be tracked down, and it may well be that there were no unknown licensees at all. The problem was that Nortel’s records were not sufficiently complete to confirm this. In summary, the sale was to be subject to all known licenses and also unknown licenses that were commercial licenses, but the purchaser would take the patents free and clear of unknown licenses other than commercial licenses. The objective was to maximize the sale price while protecting the reliance interests of

essentially all licensees. The patent sale procedure was approved at a joint hearing of the Canadian and United States courts in the CCAA and Chapter 11 proceedings, and the sale took place in late June 2011.⁵⁹ The patents were bought by a consortium of technology companies for “a record price of \$4.5 billion.”⁶⁰

Given the cross-border nature of the proceedings, Nortel’s patent sale process needed to satisfy the requirements of both United States and Canadian law. As indicated above, Canadian law at the time of the case was unsettled. The Nortel patent sale process was designed to ensure compliance with the United States requirements—specifically, section 365(n) of the Bankruptcy Code—on the assumption that these were more stringent than Canadian law, so that if the sale process complied with the United States requirements it would also necessarily comply with Canadian law.⁶¹ The picture may have changed with the subsequent coming into force of CCAA, section 32. Section 32 is similar to section 365 of the U.S. Bankruptcy Code, with section 32(6) being loosely based on section 365(n). However, there are some potentially significant differences. First, CCAA section 32 clearly requires the debtor to identify the specific agreement it wants to disclaim, whereas section 365 is more open to interpretation on this point. The difference matters in cases like *Nortel*, because if the debtor’s objective is to disclaim licenses it is unaware of, it will not be in a position to provide details of individual agreements.⁶² Second, in contrast to section 365(n), section 32(6) does not give the counterparty licensee a choice when the license is disclaimed between treating the agreement as terminated and retaining its rights under the

⁵⁹ Following the joint hearing, the U.S. court and Canadian court made separate orders: see *In re Nortel Networks, Inc.*, No. 09–10138 (KG), 2011 WL 4831218 (Bankr. D. Del. July 11, 2011); *Re Nortel Networks Corporation (Certain Patents and Other Assets Bidding Procedures Order)* (unreported, Can. Ont. Ct. Justice, 2 May 2011).

⁶⁰ Joseph Pasquariello and Chris Armstrong, *The Nortel Stalking Horse Sales: Maximising Value Via CCAA Flexibility*, 1 J. INSOLVENCY INST. CAN. 123, 137 (2012). The consortium comprised Apple, Ericsson, Microsoft, Research in Motion, EMC Corporation, and Sony.

⁶¹ *Id.* at 135.

⁶² *But see id.* at 136 (arguing that a court might be prepared to accept less specific characteristics, such as a description of the general nature or type of agreement, so long as the details were sufficient to enable counter-parties to identify the agreements the debtor is proposing to disclaim).

agreement to use the intellectual property for the duration of the term. Section 32(6) simply provides that disclaimer does not affect the licensee's right to use the intellectual property for the duration of the term.⁶³

In the *Nortel* case, the debtor relied on the rejection (disclaimer) rules to avoid the unknown licenses. What might the result have been if it had relied on the asset sale provisions instead? Section 363 of the U.S. Bankruptcy Code permits a debtor to sell its assets free and clear of third party interests, but only if "applicable nonbankruptcy law permits sale of such property free and clear of such interest."⁶⁴ As a matter of U.S. patent law, the transferee of a patent acquires title subject to any prior license, whether or not it knew of the license.⁶⁵ Therefore, if Nortel had proceeded under section 363, it could not have sold the patents free and clear of the unknown licenses. In the *Nortel* case, given the cross-border nature of the proceedings, the sale process had to comply with the requirements of both U.S. and Canadian law. But, assume that Canadian law alone had been in play and Nortel had sold the patents pursuant to CCAA, section 36. Would the sale have extinguished the licenses? It is to this question that we now turn.

IV. ASSET SALES

Assume an intellectual property owner, A, assigns the intellectual property to B and subsequently assigns the same intellectual property a second time to C. Which assignment prevails? Or suppose A grants B a license to use the intellectual property and subsequently assigns the intellectual property to C. Can B enforce the license against C? Parallel questions can arise in insolvency proceedings. For example, assume A assigns its intellectual property to

⁶³ *But see id.* at 155-56, note 22 (arguing that the counter-party should be free to waive its rights under section 32(6), even though the provision does not expressly allow for this).

⁶⁴ 11 U.S.C. § 363(f).

⁶⁵ *See* *Keystone Type Foundry v. Fastpress Co.*, 272 F. 242, 244-45(2d Cir. 1921) ("it ha[s] long passed into the text-books that . . . an assignee acquired title subject to prior licenses of which the assignee must inform himself as best he can, and at his own risk"). *See also, e.g.*, *Armstrong Pump, Inc. v. Hartmann*, 745 F. Supp. 2d 227, 233 (W.D.N.Y. 2010).

B and later files for CCAA protection; A wants to transfer the intellectual property to C, perhaps as part of a going concern sale of A's business. Can A sell the intellectual property to C free and clear of B's interest? Likewise, suppose A licenses the intellectual property to B and subsequently files for CCAA protection; can A sell the intellectual property to C free and clear of B's license?

In principle, priorities in insolvency proceedings should be the same as the priorities outside insolvency proceedings. In other words, as a general rule, the insolvency laws should not change the priority order that applies outside insolvency proceedings, because otherwise parties will have an incentive to use the insolvency laws opportunistically as a means of improving their priority position.⁶⁶ It is therefore necessary to understand the priority rules governing competing intellectual property interests outside insolvency proceedings to establish the contours of the priority regime inside insolvency proceedings. Unfortunately, in Canada the law outside insolvency proceedings is remarkably uncertain. The intellectual property statutes each provide for registration of assignments or transfers, but the priority consequences are not clear. We will consider first priority as between assignees and then priorities in respect of licenses.

A. Priorities Outside Insolvency Proceedings

1. *Competing intellectual property assignments.* – The Trade-marks Act provides that a mark is transferable and the transfer may be registered, but it is entirely silent as to the priority consequences, which therefore presumably would be determined by provincial law.⁶⁷ In common law provinces, the rule of *nemo dat quod non habet* would apply,

⁶⁶ See Thomas H. Jackson, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* chs. 1-2 (1986).

⁶⁷ Trade-marks Act, R.S.C. 1985, c. T-13, s. 48. The same is true of the Industrial Design Act, R.S.C. 1985, c.I-9, s. 13, and the Integrated Circuit Topography Act, S.C. 1990, c. 37, s. 21. "Where the ownership of a trade-mark is transferred, failure to register the change of ownership could lead to the loss of the distinctiveness of the mark. Thus a delay in the registration of an assignment does not negate the transfer, but failure to register in due course may threaten the validity of the mark." TERESA SCASSA, *CANADIAN TRADEMARK LAW* 123 (2010).

and a first assignee of legal title, or any property interest, would prevail over all subsequent interests, regardless of registration.⁶⁸

The Copyright Act does have a priority provision. Section 57(3) of the Act provides:

Any assignment of copyright, or any licence granting an interest in a copyright, shall be adjudged void against any subsequent assignee or licensee for valuable consideration without actual notice, unless the prior assignment or licence is registered in the manner prescribed by this Act before the registering of the instrument under which the subsequent assignee or licensee claims.⁶⁹

On its face this provision might seem to provide for a first-to-register priority scheme. However, in *Poolman v. Eiffel Productions*,⁷⁰ Pinard J. in the Federal Court construed the provision very narrowly. The plaintiff claimed to have obtained an assignment of copyright from the author in 1964.⁷¹ The defendant obtained an assignment of the copyright from the author in 1989.⁷² The defendant had no knowledge of the purported prior assignment to the plaintiff.⁷³ In 1991, the plaintiff presented for registration at the Copyright Office the assignment that had been executed in 1964.⁷⁴ The plaintiff claimed priority on the basis either of prior assignment or prior registration.⁷⁵ Pinard J. held for the defendant.⁷⁶ There are two points of interest. First, Pinard J. held that section 57(3) does not establish a first-to-register priority regime. Indeed, it does not establish any priority regime at all: “the registering of the instrument under which an interest in a copyright is granted is not compulsory and, except as expressly

⁶⁸ Roderick J. Wood, *Security Interests in Intellectual Property: Rationalizing the Registries*, in SECURITY INTERESTS IN INTELLECTUAL PROPERTY 699, 671 (Howard Knopf, ed., 2002).

⁶⁹ Copyright Act, R.S.C., 1985, c. C-42 s. 57 (2014).

⁷⁰ *Poolman v. Eiffel Productions* (1991), 35 C.P.R. 3d ¶384 (Can. Fed. Ct.).

⁷¹ *Id.* ¶ 2.

⁷² *Id.* ¶ 6.

⁷³ *Id.* ¶ 16.

⁷⁴ *Id.* ¶ 2.

⁷⁵ *Id.* ¶ 4.

⁷⁶ *Id.*

provided . . . in s.57(3) above, creates nothing more than a presumption of ownership of such interest that can be rebutted.”⁷⁷ Second, Pinard J. held that ownership was to be determined as a matter of provincial law, which in this case was the law of Quebec, where all the transactions had taken place.⁷⁸ On the facts, and relying on the Quebec Civil Code, Pinard J. held that, even if the plaintiff had in fact taken an assignment of the copyright from the author in 1964, the defendant’s later assignment prevailed as being a “commercial sale” without notice of the prior assignment.⁷⁹ The defendant was therefore the owner of the copyright.⁸⁰

As Professor Vaver has remarked, *Poolman* effectively “subordinated the whole federal scheme” to provincial law.⁸¹ *Poolman* implies that in a common law province, therefore, the rule of *nemo dat quod non habet* would apply, as discussed above, and a first assignee would prevail whether or not it was the first to register.⁸² Indeed, even a first assignee who failed to register at all would prevail, so long as they could prove the assignment, since registration “creates nothing more than a presumption of ownership.”⁸³

Vaver describes *Poolman* as “doubtful” on the basis that “[t]he *Copyright Act* provides its own national registration and priority scheme for copyrights. Little room seems left for the different provincial

⁷⁷ *Id.* ¶ 24.

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ *Id.* ¶ 27

⁸¹ DAVID VAVER, COPYRIGHT LAW 248 (2000).

⁸² Wood, *supra* note 68.

⁸³ It is not clear what independent effect Pinard J. would give to s. 57(3). He stated that “This provision of the Copyright Act states only that a prior assignment of an interest in a copyright must be adjudged void as against any subsequent assignee unless such prior assignment is duly registered before the registering of the instrument under which the subsequent assignee claims.” But, it is not clear what this means if it does not apply on the facts of *Poolman* itself. *But cf.* Apotex Inc. v. Wellcome Foundation Ltd., [2002] (2001) 1 F.C. 495, ¶ 100 (Can. Fed. Ct.) (where Rothstein J., in *obiter*, read s.51 of the Patent Act as establishing a first to register priority rule. Patent Act, R.S.C. 1985, c. P-4, s. 51 is in similar terms to Copyright Act, R.S.C., 1985, s. 57(3) (2014)).

schemes to operate.”⁸⁴ In his view, under the priority scheme established by section 57(3), registrable interests

usually take priority in order of registration. If the grants are unregistered, the later grant has priority if taken for valuable consideration without actual notice of the prior grant. Otherwise unregistered grants are subordinated to later registered grants, except perhaps where reliance on the registration is fraudulent.⁸⁵

Vaver’s interpretation is a straightforward reading of the provision, and to date *Poolman* has not been judicially re-considered. It is entirely possible that a different court would view the Copyright Act as enacting a complete code, as Vaver suggests.

The priority provision in the Patent Act is section 51:

Every assignment affecting a patent for invention, whether it is one referred to in section 49 or 50, is void against any subsequent assignee, unless the assignment is registered as prescribed by those sections, before the registration of the instrument under which the subsequent assignee claims.⁸⁶

This is in slightly different terms than section 57(3) of the Copyright Act, but it is sufficiently similar that the same problem will arise as to whether it constitutes a complete code.⁸⁷ One difference between the two provisions is that section 57(3) specifically subordinates interests taken with actual notice of a prior interest, while section 51 of the Patent Act does not. Nonetheless, it has been held in the patent context that a party taking with actual notice of a prior

⁸⁴ VAVER, *supra* note 81, at 248.

⁸⁵ *Id.* at 248-49

⁸⁶ Patent Act, R.S.C. 1985, s. 51.

⁸⁷ The registration provision of the Plant Breeders’ Rights Act, S.C. 1990, c. 20, s. 31(3), is also in similar terms. The Patent Act priority provisions have recently been amended. . In particular, t s. 51 has been renumbered s. 49(4), and it has been redrafted to read as follows: “A transfer of a patent that has not been recorded is void against a subsequent transferee if the transfer to the subsequent transferee has been recorded.” The new wording does not appear to affect the substance of the provision.

interest will be subordinated, so this difference on the face of the Acts does not amount to a difference in the law.⁸⁸

2. *Priorities relating to licenses.* - Given the uncertainty regarding priority between assignees, it should not be surprising that the priority of licensees is also uncertain. The traditional view is that a license is non-proprietary in nature and that it gives the licensee a mere contractual right against the licensor. Consequently, at common law the *nemo dat* rule of priorities would not apply to give a licensee priority against a subsequent transferee of the intellectual property. On the contrary, the position is that, since equity will not order specific enforcement of the license against a party who was not in privity, a subsequent transferee of the intellectual property will have priority over a prior licensee, even if the subsequent transferee had actual knowledge of the license.⁸⁹

Intellectual property licenses have traditionally been assimilated to licenses generally, as not giving a proprietary interest.⁹⁰ The Supreme Court of Canada has said that, under the Copyright Act, an exclusive licensee has “a limited property interest in the copyright,”⁹¹ at least to the extent that an exclusive licensee can sue in its own name, though at the same time the Court confirmed that the interest of a non-exclusive intellectual property licensee is entirely non-proprietary.⁹² The Patent Act is even broader; it gives any subordinate interest holder the right to sue in its own name, though the patent owner must be joined.⁹³ Similarly, under the Trade-marks Act, any licensee can sue in its own name if the owner fails to institute an action at the licensee’s request.⁹⁴ In *Heap v. Hartley*, the leading case for the general proposition that an intellectual property license is not proprietary in nature, the question at issue was whether an exclusive

⁸⁸ *Colpitts v. Sherwood* (1927), 3 D.L.R. 7 (Can. C.A.).

⁸⁹ *King v. Allen* (1916), 2 A.C. 54 (H.L.); see Richard E. Gold, *Partial Copyright Assignments: Safeguarding Software Licensees Against the Bankruptcy of Licensors*, 33 CAN. BUS. L.J. 193, 206-07 (2000).

⁹⁰ *Heap v. Hartley* (1889), 42 Ch.D. 461 (C.A.); *Euro-Excellence Inc. v. Kraft Canada Inc.*, [2007], 3 S.C.R. 20, 28 (Can.).

⁹¹ *Euro-Excellence*, 3 S.C.R. 2 at 22.

⁹² *Id.* at 28.

⁹³ Patent Act, R.S.C. 1985, s. 55.

⁹⁴ Trade-marks Act, R.S.C. 1985, s. 50(3).

licensee could sue in its own name.⁹⁵ The specific holding in *Heap v. Hartley*, that it cannot, has therefore been legislatively reversed.⁹⁶ However, the ability to sue in one's own name is only one indication of a proprietary interest, and it is doubtful that this characteristic would make an exclusive license proprietary for priority purposes as well.⁹⁷ In other words, the fact that an exclusive license is proprietary for the purposes of bringing suit probably does not suffice to make it proprietary for priority purposes.

The question, therefore, is the extent to which the statutory priority provisions operate to affect the priority of licensees. As the Trade-marks Act has no priority provisions, the priorities of licenses will depend on provincial law.⁹⁸ If *Poolman* is good law, the same is true with respect to patent and copyright licenses, notwithstanding any registration.

If, on the other hand, the statutory provisions of the Copyright Act and the Patent Act do provide a complete code, the priority of licenses will turn on the interpretation of those provisions. Under the Copyright Act, any "licence granting an interest in [a] copyright" is registrable⁹⁹ and treated in exactly the same manner as an assignment for priority purposes under section 57(3). It is clear that an interest in a copyright includes an exclusive license, and Professor Vaver has

⁹⁵ *Heap*, 42 Ch.D. at 464-65.

⁹⁶ *See generally id.*

⁹⁷ The Supreme Court in *Euro-Excellence*, referred to the property interest as "limited" and it cited statutory provisions, inferring that these granted the exclusive licensee the right to sue in its own name; so it may be that the reference to a "limited proprietary interest" was no more than a label for a conclusion regarding the interpretation of the Act on this point, with no wider implications. The Court also stated that the property interest of the exclusive licensee "does not include an interest that defeats the ownership interest of the licensor." *Euro-Excellence*, 3 S.C.R. ¶ 34. This implies, without stating directly, that it could not defeat the ownership interest of a party claiming under the licensor.

⁹⁸ The Canadian Intellectual Property Office now allows registration of security interests under that provision; James G. Fogo, *Assignment and Licensing of Trade-marks*, in *TRADE-MARKS LAW OF CANADA* 165, 175 (Gordon F. Henderson, ed., 1993). (The registration provisions of the Trade-marks Act provide for the registration of the "transfer" of any registered mark. At one time "transfer" was interpreted by the Canadian Intellectual Property Office to mean only the outright assignment in full of all rights.)

⁹⁹ Copyright Act, R.S.C., 1985, s. 53(2.2) (2014).

argued that it also includes an irrevocable non-exclusive license, especially if the licensee has invested in reliance on the license.¹⁰⁰ If that is so, then irrevocable non-exclusive licenses are both registrable and subject to the same priority rules as assignments.

The Patent Act priority provision is not entirely clear. Exclusive licenses are clearly registrable: section 50(2) provides that every “assignment of a patent, and every grant. . . of any exclusive right. . . shall be registered.”¹⁰¹ However, the priority provision, section 51, refers only to “every assignment,” and makes no mention of exclusive licenses. On the one hand, it would seem logical that if it is possible to register an exclusive license in the same manner as an assignment, the priority consequences of registration should be the same; on the other hand, the failure to mention exclusive licenses in the priority provision, when they are expressly mentioned in the registration provision, suggests a legislative intent to treat them differently.¹⁰²

Non-exclusive licenses are clearly not registrable at all under the Patent Act. Non-exclusive licenses may also not be registrable under the Copyright Act, as Professor Vaver’s interpretation has never been judicially tested. It is not clear which priority rules apply to unregistrable non-exclusive licenses. If, as Vaver argues, the federal statutes provide a complete code, then federal law and not provincial law should determine the priority of unregistrable interests. But there is no case law as to what such a priority scheme might be. Alternatively,

¹⁰⁰ David Vaver, *The Exclusive Licence in Copyright*, 9 INTELLECTUAL PROP. J. 163, 189 (1995).

¹⁰¹ Patent Act, R.S.C. 1985, s. 50(2).

¹⁰² As indicated in note 87, *supra*, the Patent Act priority provisions have recently been amended. Section 50(2) has been renumbered s.49(3), and it has been reworded to read as follows: “The Commissioner shall, subject to the regulations, record the transfer of a patent on the request of the patentee or . . . of a transferee of the patent.” The proposed new provision omits the reference to “any exclusive right.” Consequently, an exclusive license may no longer be registrable, unless the courts read the reference to a “transfer” as including an exclusive license.

provincial law might apply to fill the gaps in the federal priority scheme.¹⁰³

Even if they are registrable, it is generally not practical to register non-exclusive licenses, such as end-user licenses. The result is that a subsequent assignee will probably take clear of non-exclusive licenses. If non-exclusive licenses are not registrable at all, and provincial law applies, then under the common law at least the assignee will take clear, even if it has knowledge of the prior licenses. If they are registrable, but unregistered, then the assignee will take clear unless it has knowledge, as a matter of the statutory priority rules.

As a matter of policy, the basic assimilation of intellectual property licenses to licenses of real or personal property is questionable. An exclusive license of intellectual property is functionally very similar to an assignment, as the licensee's rights are normally exclusive even of the rights of the owner. On the other hand, a non-exclusive license relating to intellectual property is different from a license relating to tangible property. A license relating to tangible property will affect the licensor's ability to make use of the property itself; a license granted to allow the licensee to post advertisements on the wall of a building will prevent the licensor from doing the same. However, this is not true of intellectual property. A non-exclusive license does not prevent the licensor from making use of the intellectual property in any way; it simply prevents the licensor from suing the licensee for infringement. In this respect, giving recognition to the license-holder's rights against a third party assignee does not prejudice the assignee. On the other hand, failing to uphold the license in these circumstances may significantly prejudice the licensee who may have made substantial investments in reliance on the license. Even a non-exclusive licensee may rely heavily on a license, as where a large corporation trains its employees in the use of a suite of office productivity software. The vulnerability of non-exclusive licensees to having their interests defeated by an assignment outside of bankruptcy is therefore problematic as a matter of policy. The unsatisfactory state of the current non-bankruptcy laws in this respect

¹⁰³ This is implied by *Poolman v. Eiffel Productions* (1991), 35 C.P.R. 3d ¶384 (Can. Fed. Ct.), though the point in that case was that the Copyright Act does not provide a priority system at all.

creates a challenge for insolvency law reform: to what extent is it possible or desirable to protect the intellectual property licensee's reliance interest inside bankruptcy without simultaneously undertaking a wholesale reform of the applicable non-bankruptcy rules? We pursue this question below.

B. Priorities Inside Insolvency Proceedings

1. *Assignments.* - Assume an intellectual property owner, A, assigns its intellectual property to B and later applies for CCAA protection. As part of the CCAA proceedings, A wants to sell its intellectual property to C, perhaps as part of a going concern sale of A's business. Can A sell the intellectual property to C free and clear of B's interest? The starting point is CCAA, section 36, which deals with the sale of assets in CCAA proceedings. CCAA, section 36(1) provides that the debtor may not sell assets outside the ordinary course of business without court approval.¹⁰⁴ Section 36(3) provides that in hearing the case, the court must take account of various factors, including the effects of the proposed sale on creditors and other interested parties.¹⁰⁵ Section 36(6) provides:

The court may authorize a sale . . . free and clear of any security, charge or other restriction and, if it does, it shall also order that other assets of the company or the proceeds of the sale . . . be subject to a security, charge or other restriction in favour of the creditor whose security, charge or other restriction is to be affected by the order.¹⁰⁶

The provision appears to have been drafted with security interests and the like specifically in mind, and it does not seem to contemplate other third party interests such as the prior assignee of an intellectual property right. However, section 36 would presumably be read subject to the relevant non-bankruptcy law outlined above.¹⁰⁷ On this basis, a purchaser of intellectual property in a CCAA, section 36

¹⁰⁴ CCAA, R.S.C., 1985, s. 36(1).

¹⁰⁵ *Id.* s. 36(3).

¹⁰⁶ *Id.* s. 36(6).

¹⁰⁷ CCAA, R.S.C., 1985, s. 36 is similar to U.S. Bankruptcy Code, 11 U.S.C. § 363; § 363(f) provides specifically for a free and clear sale if "applicable non-bankruptcy law permits sale of such property free and clear of such interest."

sale would acquire title subject to any interest which would have priority under applicable non-bankruptcy law. BIA, section 65.13, which applies to BIA proposals, is in similar terms to CCAA, section 36, and so the same analysis applies. There are no corresponding provisions governing the sale of assets in bankruptcy proceedings or receiverships but, in principle, the capacity of a trustee in bankruptcy or a receiver to sell intellectual property free and clear of a prior assignee's claim should be determined by reference to non-bankruptcy law, as described above.

2. *Licenses.* - Now assume that A grants B a license to use its intellectual property and A subsequently applies for CCAA protection. Can A, as part of the CCAA proceedings, sell the intellectual property to C free and clear of B's license? Again, the starting point is the proposition that a purchaser of intellectual property in a CCAA, section 36 sale takes subject to any competing claim that would have priority outside insolvency proceedings. As indicated above, the applicable law outside insolvency proceedings is unsettled. The answer depends on whether the license is registrable so that one or other of the statutory priority rules applies. If not, then applying provincial law, C, who is not party to the license agreement between A and B, is not bound even if C was aware of the license at the date of the transfer.¹⁰⁸ This appears to be the result for trademark licenses and non-exclusive patent licenses, which are not registrable. A different result may follow if the license is registrable and registered, as in the case of an exclusive patent or copyright license. But, as discussed above, there is considerable uncertainty as to application of the Patent Act priority provision and the scope and application of the Copyright Act registration and priority provisions.

As noted above, U.S. law is significantly different in this respect. In the United States, as a general rule, outside bankruptcy an intellectual property transferee is bound by prior licenses.¹⁰⁹ This rule is imported into bankruptcy law by section 363(f) of the Bankruptcy Code, which provides that the trustee may sell assets free and clear of an interest subject to certain restrictions, including a requirement that

¹⁰⁸ See generally *Royal Bank of Canada v. Body Blue, Inc.* (2008), 42 C.B.R. 5th 125 (Can. Ont. SCJ).

¹⁰⁹ See *Keystone Type Foundry v. Fastpress Co.*, 272 F. 242 (2d Cir. 1921).

“applicable nonbankruptcy law permits sale of such property free and clear of such interest.”¹¹⁰ One problem with the current Canadian position is that, if the transferee of intellectual property takes free and clear of outstanding licenses, a licensor debtor in CCAA proceedings can do an end run around the restriction in CCAA, section 32(6) on disclaimer of intellectual property licenses: instead of directly disclaiming the license, the debtor can avoid it indirectly by assigning the underlying intellectual property to a third party purchaser. The result may be to seriously compromise the licensee’s reliance interest, which was the very concern CCAA, section 32(6) was enacted to address.¹¹¹

C. *Nortel* Revisited

As discussed earlier, the terms of Nortel’s patent sale were that buyers would take the patents subject to known licenses and commercial licenses, but free of unknown licenses. The debtor also developed a procedure aimed at giving unknown licensees an opportunity to assert their rights under section 365(n) of the U.S. Bankruptcy Code. Licensees who responded before the specified date became admitted to the “known licenses” fold, which meant that, under the terms of the proposed sale, their rights were enforceable against the purchaser. On the other hand, licensees who failed to respond in time, or at all, were deemed to have elected under section 365(n) to treat their license agreements as terminated. Consequently, the purchaser acquired title to the patents free and clear of licenses in this category.

In *Nortel*, the sale process had to comply with the requirements of both Canadian and U.S. law and, given section 363(f) of the U.S. Bankruptcy Code read in conjunction with U.S. patent law, Nortel would not have been able to sell the patents free and clear of the unknown licenses. This explains why it was forced to take the more round-about route of relying on section 365(n) instead. But if only Canadian law had applied, Nortel could have proceeded under CCAA section 36 (the asset sale provision), in which case the court would probably have applied the priority rules discussed above to determine

¹¹⁰ 11 U.S.C. § 363(f)(1).

¹¹¹ The same point applies with respect to BIA, R.S.C. 1985, s. 65.11(7) in relation to BIA proposal proceedings.

the rights of the unknown licensees. It is instructive to compare the result in *Nortel* with the result that would have followed if the Canadian priority rules had applied.

In short, the Nortel plan put the licensees in a substantially better position than they would have been in otherwise. First, under the plan the sale was subject to all known and unknown commercial licenses, including end-user license agreements. By contrast, if the Canadian priority rules had applied, the purchasers would have taken free of any such license unless—perhaps—the license was registered or the purchasers had knowledge of it. Second, while the plan provided that the purchasers were to take free and clear of any unknown license other than a commercial license, it gave unknown licensees the opportunity to identify themselves and to avoid extinguishment of their claims. Licenses in this category might have included exclusive licenses—these would certainly have been of the greatest concern to a purchaser—and so, under Canadian law, they would have been registrable, and a registered license probably has priority over the claim of a subsequent transferee. In effect, the plan excused the holders of registrable licenses for their failure to register by giving them a second chance to publicize their claims.

The generosity of the Nortel plan brings into sharp relief the inadequacy of current Canadian law in terms of protecting intellectual property license holders both inside and outside insolvency proceedings. BIA section 65.11(7) and CCAA section 32(6) protect the licensee against extinguishment of its interest following disclaimer by the licensor-debtor. As noted above, however, these reforms are compromised to the extent that the licensor-debtor can sell the underlying intellectual property interest free and clear of current licenses. As it happens, the Nortel plan avoided this concern, but the Nortel plan was substantially shaped by the requirements of United States law, and there can be no guarantee that licensees will be as generously provided for in future cases.

V. POSSIBLE REFORMS

In the interests of economy, the following discussion focuses mainly on patents.¹¹² A partial response to the problem identified in Part IV above, would be to amend CCAA, section 36 and the corresponding provision in BIA, section 65.13 to make it clear that the court may authorize a sale of assets, including patents and other intellectual property, free and clear of third party claims, but only if the laws that apply outside insolvency proceedings allow for free and clear sales. This measure would bring the Canadian rules relating to asset sales in insolvency proceedings more closely into line with the U.S. position.

However, in the United States, the laws that apply outside bankruptcy to the enforceability of a patent license against a transferee of the intellectual property are well-established, and they favor the licensee. By contrast, the corresponding Canadian laws are uncertain, under-developed, and outdated. It follows that a comprehensive solution to the issue in *Nortel* requires reform of not only the insolvency laws, but the patent laws as well. Specifically, the patent registration system should be expanded and modernized, and the Patent Act itself should be amended to provide comprehensive and coherent priority rules for competing claims. These new priority rules would apply in insolvency proceedings in the same way they apply outside insolvency, with the result that it would make no difference to the parties' relative entitlements whether the priority issue arises in the context of insolvency proceedings or outside the insolvency system.¹¹³

A simpler and quicker response might be to amend BIA, section 65.13 and CCAA, section 36 to make it clear that, while the provisions extend to the sale of patents and other intellectual property, the court may not authorize the sale of intellectual property free and

¹¹² Somewhat different considerations may apply to other types of intellectual property for which registration is not a requirement.

¹¹³ See INTELLECTUAL PROPERTY INSTITUTE OF CANADA, POSSIBLE AMENDMENTS TO THE PATENT ACT AND PATENT RULES 13 (2013) (the Intellectual Property Institute of Canada has recognized the need for reforms more or less along these lines: “[c]larify interplay between registrations under the *Patent Act/Personal Property Security Act* and bankruptcy proceedings under the *Bankruptcy and Insolvency Act/Companies’ Creditors Arrangement Act*.”).

clear of current licenses.¹¹⁴ While a quick fix like this might be tempting, given the challenges that would be involved in overhauling the intellectual property laws, the temptation should be resisted. Taking this approach would create a discrepancy between insolvency law and the law that applies outside insolvency proceedings in the treatment of intellectual property licenses. Specifically, the reforms would put the intellectual property licensee in a stronger position, relative to a transferee of the intellectual property, in the transferor's insolvency proceedings than it would be outside insolvency. As a general rule, priority flips of this nature are inadvisable because they encourage parties to use the insolvency laws opportunistically to improve their priority position. Furthermore, the proposed reforms would create a discrepancy between cases where the financially troubled debtor's asset sale takes place in insolvency proceedings and cases where the asset sale is conducted outside the insolvency system. In *Nortel*, the patent sale took place in the course of CCAA and Chapter 11 proceedings. By contrast, Blackberry, another financially troubled technology company, was until recently planning to sell its patent portfolio without relying on the insolvency laws. Had the Blackberry sale gone ahead, licensees' interests would have been governed by the non-bankruptcy priority rules described above. But there is no principled reason why the parties' entitlements, relative to one another, should vary depending on whether the sale happens to take place inside or outside insolvency proceedings.¹¹⁵

¹¹⁴ Or at least: (1) a prior registered license; (2) a prior unregistered licensee of which the purchaser has knowledge; or (3) a license granted in the ordinary course of the licensor's business (for example, to an end-user).

¹¹⁵ The reforms proposed above may have conflict of laws implications, for example, where a patent is registered in Jurisdiction A and the patent sale takes place in Jurisdiction B. The conflict of laws issues are complex and require separate study. See LEGISLATIVE REVIEW TASK FORCE (COMMERCIAL) OF THE INSOLVENCY INSTITUTE OF CANADA AND THE CANADIAN ASSOCIATION OF INSOLVENCY AND RESTRUCTURING PROFESSIONALS, REPORT ON THE STATUTORY REVIEW OF THE BANKRUPTCY AND INSOLVENCY ACT AND THE COMPANIES' CREDITORS ARRANGEMENT ACT 8 (2014) (identifying some of the issues). See also UNCITRAL, LEGISLATIVE GUIDE ON SECURED TRANSACTIONS: SUPPLEMENT ON SECURITY RIGHTS IN INTELLECTUAL PROPERTY, Part X., U.N. Sales No. E.11.V.6 (2011).

CONCLUSION

The Canadian insolvency laws, similar to the U.S. Bankruptcy Code, limit an intellectual property owner's freedom in insolvency proceedings to disclaim licenses it has granted. The purpose of this limitation is to protect the licensee's reliance interest and to prevent disruption of the licensee's business. If the insolvency laws freely allowed disclaimer of intellectual property licenses, they would increase the up-front risk to prospective licensees and might have a chilling effect on the licensing of intellectual property to the detriment of both licensors and licensees.

Logically, this policy should also be reflected in the provisions governing asset sales so that at least as a general rule, it should not be possible for an intellectual property owner in insolvency proceedings to sell the intellectual property free and clear of current licenses. However, while this appears to be the law in the United States, the position in Canada is much less certain. In principle, a Canadian bankruptcy court should approach the issue with reference to the rules which apply outside bankruptcy to priority disputes between competing claims to intellectual property. But the applicable non-bankruptcy laws, as they currently stand, are fragmented, complex, and unsettled. The laws are badly in need of reform.

It might be possible to amend the insolvency laws without also reforming the intellectual property laws. However, this would be a second-best solution. The problem is that it would make the licensee's position stronger or weaker, relative to a transferee of the intellectual property, depending on whether the sale takes place inside or outside insolvency proceedings. In other words, tackling the problem *via* the insolvency laws, without reforming the intellectual property laws, may result in arbitrary case outcomes and may induce debtors to favor asset sales outside the insolvency system with a view to defeating licensees' interests.

In any event, there is some urgency about the need for reform because sales of intellectual property, and patent portfolios in particular, are becoming increasingly common. The uncertain state of the law threatens to reduce the returns from such sales because it means parties must take expensive and time-consuming steps, as in

Nortel, to clarify the purchaser's title. It also threatens to reduce the returns from the licensing of intellectual property because, as matters presently stand, a prospective licensee cannot be sure that its license will still be valid if the underlying intellectual property is subsequently transferred.¹¹⁶

In today's economy almost every business depends on licensed intellectual property rights to a greater or lesser extent, and consequently every business is potentially exposed to the threat of "hold-up" by patent assertion entities which have acquired intellectual property rights from a licensor in financial distress. This is not a remote or theoretical problem; it is happening regularly around the world. There is no question that the problem will come to Canada, if it has not already. The only question is whether we will be ready when it does arrive.

¹¹⁶ See NATIONAL RESEARCH COUNCIL OF THE NATIONAL ACADEMIES, PATENT CHALLENGES FOR STANDARD-SETTING IN THE GLOBAL ECONOMY: LESSONS FROM INFORMATION AND COMMUNICATIONS TECHNOLOGY (2013) (see Chapter 5 dealing with transfers of patents with licensing commitments, and especially Chapter 5.2 discussing recent cases from around the world, including *Nortel*).