How insolvency laws impact IP licences

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One of the biggest risks of acquiring intellectual property rights through licensing is licensor insolvency. An insolvent licensor could jeopardise the validity of the licence and potentially the licensee's business. The impact depends on the insolvency laws of the country where the licensor is located, and approaches across jurisdictions vary considerably.

We are approaching the second anniversary of the date when the European Commission first published its Proposal for a **Directive harmonising certain aspects of insolvency law** in the European Union. The proposed directive aims to provide a level of harmonisation for certain aspects of insolvency laws across the EU, to encourage and facilitate cross-border investment and competition. While Article 27 of the proposal includes specific protections for IP licences, the European Economic and Social Committee's negative reaction to Article 27, as set out by its recently published **Opinion**, suggests that this may be subject to change.

This article examines the current legal position in relation to the validity of licence agreements under the insolvency laws in the United Kingdom, Germany and the United States, how the proposed directive compares against these insolvency regimes, the status of the proposal, and what steps parties could take to prepare for such potential legislative changes.

Current position: US, UK and Germany

United States

Section 365 of the **US Bankruptcy Code** deals with the treatment of executory contracts in bankruptcy cases. A contract is executory if both parties have material unperformed obligations, which typically is the case for IP licences.

Section 365 provides the licensor in bankruptcy (or its trustee) with the option to either assume or reject the IP licence. However, Section 365(n) offers the licensee specific protections regardless of the licensor's decision, as the licensee can either elect to retain its IP rights under the licence for the remaining term of the contract, subject to the licensee's payment of any royalties due under the licence, or treat the contract as terminated by rejection and submit a claim for damages.

In practice, the licensee's choice often comes down to whether the licensed product or technology is critical for the continuation of its business.

However, Section 365(n) is subject to certain limitations. The licensor has no obligation to perform under the licence, such as to continue to maintain or develop the IP. Section 365(n)'s protection is also limited to IP in existence at the time of the filing, thus excluding contingent rights and any improvements or developments after the filing date.

Further, Section 365(n) applies only to "intellectual property" as expressly defined in the Bankruptcy Code. This definition covers only: trade secrets; inventions, processes, designs, or plants protected under Title 35; patent applications; plant varieties; works of authorship protected under Title 17; and mask works protected under Chapter 9 of Title 17. Notably, Section 365(n) likely does not apply to ex-US patents.

Moreover, on the face of the definition alone, trademarks and general know-how do not benefit from the Section 365(n) licensee protections. However, the US Supreme Court in ***Mission Product Holdings, Inc. v Tempnology LLC 2019*** held that trademark licensees may nonetheless enjoy similar protections because rejection by a debtor licensor operates not as a rescission of contract rights, but only as a breach.

Under applicable (non-bankruptcy) law, a trademark licensee's rights are not revoked upon breach, and, thus, such trademark rights also survive a debtor licensor's rejection (breach) of a trademark licence in bankruptcy. By extension, a licensee could also have the right to use general know-how or other IP that is outside the scope of Section 365(n) after rejection of the licence agreement. However, the exact reach of *Tempnology* is yet undetermined and will likely be clarified by future case law.

United Kingdom

The UK insolvency framework relating to IP licences is governed by the **Insolvency Act (IA) 1986** and should also be considered in light of the **Corporate Insolvency and Governance Act (CIGA) 2020**.

IP licences are assessed in the same way as other contractual agreements. While there is no automatic right to terminate a licence in the event of insolvency, insolvency practitioners have substantial flexibility in dealing with the performance of debtors' contractual obligations entered into prior to the commencement of insolvency proceedings.

The insolvency practitioner may decide to assign the underlying IP, and if the assignee is a purchaser in good faith for valuable consideration without actual or constructive notice of the licence, they will not take the IP subject to the licence. Therefore, licensees of registered IP rights should ensure that the licence is duly registered at the relevant office.

Alternatively, under Section 178 of the IA, liquidators have the option to disclaim onerous property, including unprofitable contracts. Accordingly, IP licences with, for example, financially unfavourable terms binding the licensor could potentially be disclaimed by the liquidator. However, disclaimer only terminates the rights, interests and liabilities, such as active obligations, of the licensor while allowing the licensee to retain its rights under the disclaimed IP licence with the condition that the licensee complies with their obligations.

The liquidator may also disclaim the underlying IP. In the event the licensee suffers loss as a consequence of such disclaimer, it has the right to prove for its loss, as an unsecured creditor, in the licensor's winding up.

If the underlying IP has neither been assigned nor disclaimed by the insolvency practitioner and the licensor is dissolved, then the IP passes to the Crown bona vacantia, creating an opportunity for the licensee to purchase it at full market value.

Further, the licensee may apply to court for an order for rescission of the licence against the liquidator under Section 186 of the IA. The order of rescission may contain terms as to payment of damages for the non-performance of the contract. However, this type of claim is likely to be made on an unsecured basis, making it potentially unlikely for the licensee to recover any damages in practice.

Germany

Similarly to the UK, there is no statutory provision that explicitly deals with the treatment of IP licences in the insolvency context under German insolvency law. However, German courts treat IP licences as mutual contracts, for the purpose of the **German Insolvency Code**. Under s.103 of the German Insolvency Code, regarding mutual contracts generally, the insolvency administrator can decide whether or not to continue an IP licence depending on how economically viable the relevant licence is for the debtor licensor's business.

If the administrator decides to continue such a licence, the rights and obligations will remain in force under the contract. On the other hand, if the administrator rejects to perform the contract, the only protection for the other party (the licensee) is that it is entitled to claim for non-performance only as an insolvency creditor.

As in the UK, such claims in Germany will also be treated as unsecured claims only against the insolvency estate. Additionally, any provision in an agreement that rules out or limits the insolvency administrator's right to continue or discontinue the licence under s.103 is void (s.119).

The proposed directive and its impact on IP licences

The proposed directive sets out a potential new EU regime for "pre-packed" insolvency proceedings, which are "expedited liquidation proceedings that allow for the sale of the business of the debtor, in whole or in part, as a going-concern to the best bidder" (Article 2(p)). It therefore reinforces the fundamental assumption that the sale of a distressed business as a going concern recovers more value to creditors, rather than piecemeal liquidation of business assets. By laying down common rules on incorporation of pre-pack proceedings into insolvency regimes across Member States, the proposed directive aims to facilitate an effective roll-out of efficient and transparent pre-pack proceedings (Title IV).

Article 27(1) requires Member States to ensure that any potential acquirer of the debtor's distressed business in pre-packed insolvency proceedings is assigned the executory contracts that are *necessary* for the continuation of the debtor's business and the suspension of which would lead to a business standstill.

Article 27(2) goes on to state that the Member State can terminate such necessary contracts in the event that (a) termination is in the interest of the debtor's business, or (b) it contains public service obligations. But under Article 27(2), section (a) is disapplied with respect to "licences of intellectual property and industrial property rights" – recognising that IP licences are a different category of contracts that can only be terminated under more limited circumstances.

However, the meaning of "necessary" in this context of Article 27 is not defined and there is potential for necessity to be narrowly construed. We will likely have further clarification on the scope of Article 27 as the proposed directive progresses through the European legislative process and once Member States transpose it into national law.

We note that, unlike the US position, it is not possible for the debtor licensor or its insolvency trustee to outright reject the IP licence that falls within Article 27 of the proposed directive. This could be a reason for the debtor to be less inclined to opt for the pre-pack sale option, in particular if there are significant outstanding licensor obligations.

Next Steps for the proposed directive

The proposed directive is going through the legislative procedure where it will need to be approved by the Council of the EU and the European Parliament before it can enter into force. Member States will have two years from its entry into force to transpose it into national law. There are likely to be some variations in how it is transposed, given that the Proposed Directive provides only for *minimum* harmonisation requirements.

While the UK is not an EU member, it is one of the few countries in Europe with a robust pre-pack procedure already in place, and we may see the UK follow suit along similar lines and utilise the proposed directive to further streamline pre-pack procedures across the UK.

Following the elections for the European Parliament that took place across EU Member States in June of this year, a new Commission is in the process of being appointed, including a **Commissioner for Financial Services and the Savings and Investments Union**. In light of the recent appointment of a new European executive, the public is awaiting developments on the matter.

On the other hand, the European Economic and Social Committee's recently published **Opinion** urges the Commission, the Parliament and the Council to revise the proposal in Article 27 on the basis that it obliges suppliers, as counterparties to executory contracts, to contract with a partner (the assignee of the contract) they have not freely chosen or vetted.

How can companies prepare?

Licensees might wish to maximise the possibility of the licence to be eligible for the Article 27 protections in the event the proposed directive comes into force and a pre-pack insolvency process is chosen by increasing the chance of the agreement being interpreted as "necessary". For example, if a biotech licensor relies on the revenues from the licence on an ongoing basis, the licensee might seek to structure the payments by way of ongoing fees (eg, milestones and royalties) rather than an upfront payment so, as a result of such reliance by the licensor's business, the payments may continue in the face of insolvency.

Licensees should continue to consider mitigation measures that are applicable regardless of the proposed directive, depending on the licensor jurisdiction. These measures may include registering exclusive licences at the relevant IP offices, having a security interest over the licensed IP or options to acquire the IP, considering alternative structures for holding critical IP in insolvency-remote entities, and, as a pragmatic measure, contractually reducing the credit risk of the licensor, by including set-off rights against future payments in the event the licensor is unable to pay out-of-pocket for claims.

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