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CONTOURS OF INTELLECTUAL PROPERTY LICENSE DURING INSOLVENCY

M. P. Ram Mohan and Aditya Gupta

Insolvency proceedings, as opposed to any other legal proceedings, are unique. The filing for insolvency not only results in a complete reshuffling of the rights of the debtor and the various classes of claimants, but it also overrides the legal rights that exist outside the formal insolvency proceedings.[1] Given the breadth of its application and interception, domestic insolvency regimes involve an intersection of a diverse mosaic of legal rules,[2] rightfully earning insolvency law the title of a 'meta-law'.[3]

Intellectual property (IP) licensing is a particular intersection of insolvency regulation that has resulted in intense judicial controversy and scholarly disagreement. From judicial misinterpretation[4] and disagreement[5] to congressional course correction[6] and cross-border uncertainty,[7] the intersection of IP licensing with insolvency has witnessed many controversies. Interestingly, the issue of IP licensing in bankruptcy remains unexplored in Indian bankruptcy jurisprudence. Partial blame for the situation can be accrued to the fact that before 2016, the Indian insolvency regime remained 'multi-layered and fragmented'.[8] In 2016, the Insolvency and Bankruptcy Code, 2016 (IBC / Code) substituted a multitude of operational bankruptcy laws. However, even the IBC does not explicitly regulate issues of IP licensing in insolvency transactions.[9]

This article relies on the American bankruptcy jurisprudence to identify judicial disputes where the intersection of bankruptcy laws with IP licenses has yielded problematic conclusions. These judicial disputes are then examined within the mandate of IBC. The individual provisions of the Code are examined to determine the scope of interference warranted within the remit of the Indian insolvency regime.

EXECUTORY IP LICENSES IN BANKRUPTCY

Implications for domestic insolvency

IP licenses and their regulation within bankruptcy share a controversial history in American bankruptcy jurisprudence.[10] The judicial and academic disagreements regarding this intersection can be traced back to section 365 of the American Bankruptcy Code. The provision allows a bankruptcy debtor to reject onerous contracts that were entered into before the initiation of the insolvency proceedings.[11] Rejection allows a bankruptcy estate to absorb the contractual arrangements offering a net benefit while rejecting potentially burdensome arrangements.[12] Rejecting burdensome and onerous contractual covenants reduces the prospective debts and the overall corpus of available funds to a business. These funds can then be restructured into payments to creditors.[13]

The threshold requirement for the application of section 365 is that the contract must be 'executory'. While the American bankruptcy law does not define the term executory, judicial and academic commentary provides sufficient guidance to create a workable definition.[14] Prof. Vern Countryman suggests that an executory contract would be '*a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach*'.[15] This definition has assumed approval from the judiciary[16] as well as the American Congress.[17] Since IP licenses usually include continuing material obligations,[18] an overwhelming majority of courts find such licenses to be executory.[19]

Once the threshold inquiry of executoriness is completed, the debtor is allowed to reject a license.[20] Once rejected, the non-bankrupt party's claim is relegated to a pre-petition general unsecured claim,[21] which usually receives only a fraction of the original claim.[22] Once rejected, the contract is treated as if the rejecting party breached it.[23] However, owing to US Congress' omission to enlist the repercussions of the breach and the lack of an obvious contract law analogue to the term 'rejection', the interpretation of this provision has been far from consistent.[24]

Applying the rejection principle becomes even more problematic when it intersects with IP licenses.[25] In 1985, the US Court of Appeals for the Fourth Circuit in *Lubrizol v. RMF* interpreted that the rejection of an IP license would not only free the licensor from material foregoing obligations but it would also restrain the licensee from using the licensed IP.[26] The court's decision effectively meant that a rejection of an IP license within section 365 would constitute complete recission of the license.[27] After the decision, licensees realised that in a case of bankruptcy, they were extremely vulnerable to a rejection of the license by a bankrupt licensor. The decision was met with an immediate demand to structure transactions as complete sales, thirty party software escrows and requiring security interest in the licensor's estate.[28]

The potential effects of the *Lubrizol* ruling on the IP licensing market were so dire that American Congress had to adopt the Intellectual Property Bankruptcy Protection Act, 1988 (IPBPA) to denude *Lubrizol* from its precedential authority.[29] The Act introduced section 365(n) into the legislative scheme of the American Bankruptcy Code.[30] The section provides an option to the licensee to retain the continued rights to exploit the licensed IP post rejection.[31] While such retention would release the licensor from his set of contractual obligations, the licensee would continue using the licensed IP.[32] Hence, section 365(n) acts as a substantial 'veto power' allowing the licensee to determine the effect of the rejection of an IP license.[33]

Despite the clear and absolute enunciation of the law by IPBPA, the controversy related to IP licenses continued in American bankruptcy jurisprudence till 2019. When the IPBPA was legislated, the Congress omitted trademarks from the definition of IP.[34] This omission led numerous courts to argue that the treatment of IP licenses as decided by *Lubrizol* should continue to apply in the trademark licenses.[35] In 2019, the United States Supreme Court confirmed that the concerns of distorted competition, which underlined the promulgation of IPBPA, should also extend to trademark licensing.[36]

Implications for cross-border insolvency

Apart from domestic insolvency, inconsistency related to IP licensing in bankruptcy has also yielded problematic results in cases of cross-border insolvency. In January 2009, a manufacturer of semiconductor chips, Qimonda, initiated insolvency proceedings in Germany. Since a significant proportion of Qimonda's IP assets were registered in the US, the proceedings assumed the nature of a cross-border insolvency.

The US Bankruptcy Code, through Chapter 15, adopts the United Nations Commission on International Trade Law (UNCITRAL) Model Law on Cross-Border Insolvency, 1997. Making very 'narrow and limited' deviations from the Model Law,[37] Chapter 15 allows a foreign bankruptcy representative to file a petition for recognition of foreign insolvency proceedings and request administration of American assets.[38] The US Bankruptcy Code allows a foreign representative to file an application for recognition of foreign proceedings[39] and request the administration of American assets.[40] Citing his entitlements, the German Trustee requested the administration of Qimonda's 4000 patents registered in the US. However, there was a potential difference between the treatment of bankrupt debtor's IP licenses in the bankruptcy legislations of the US and Germany. While the American Congress had legislated IPBPA, protecting the interests of licensees during the debtor's bankruptcy, a concomitant protection was absent from the scope of the German insolvency legislation. Within the German insolvency law, it was possible that a rejection of an IP license would amount to its complete recission.[41]

When the dispute was presented before an American Bankruptcy Court, the German Trustee's application to transfer administration of assets was denied. In its decision, the court relied on the public policy limitation, which allows a bankruptcy court to '*refuse to take any action under Chapter 15 if such action would be manifestly contrary to the United States Public Policy*'.[42] The Court argued that IPBPA constitutes 'fundamental US public policy of promoting technological innovation'.[43] Therefore, any deviation from the protections offered therein would violate US public policy, thus activating the 'safety valve' embodied in the public policy limitation.

On appeal, the US Court of Appeals for the Fourth Circuit relied on a different argument to arrive at the same conclusion as the Bankruptcy Court. The Circuit Court argued that the administration of assets was a discretionary relief and can be granted only if '*the interests of the creditors and other interested parties, including the debtor, are sufficiently protected*'.[44] The court argued that any grant of discretionary relief inherently calls for a 'balancing test', where the countervailing interests of the creditors must be considered alongside the interests of the debtor. In the present case, when Qimonda's licensees approached the bankruptcy court citing the potential detriment to their interest by reason of unilateral rejection, the court opined that the licensees should be sufficiently protected in the grant of a discretionary relief even if it adversely affects the bankrupt debtor. The court opined that licensing agreements' unilateral recission could constitute an overwhelming burden on the licensees. Such a conclusion tilted the balancing test in favour of the licensees. Arguing thus, the application for transfer of administration was denied.[45]

The confluence of the two arguments and the courts' decisions meant that the licensees of the American patents would receive a dramatically different treatment compared to German licensees.[46] While the decision received considerable criticism in academic scholarship,[47] the United States Supreme Court rejected an appeal of *certiorari* against the Circuit Court judgement.[48] Therefore, the decision in *Qimonda v. Jaffe* substantially colours the conduct of the courts and the parties in a cross border insolvency dispute involving IP licenses, particularly in the American jurisdiction. Further, given the close association that Chapter 15 shares with the Model Law, it is possible that the decision in *Qimonda* can colour the interpretation of the Model Law itself.[49]

TREATMENT OF EXECUTORY IP LICENSES IN INDIA

Unlike the US and some other countries,[50] the IBC does not explicitly protect IP licensees.[51] Partial blame for this situation can be accrued to the fact that international projects dealing with contractual relationships fail to provide any guidance on the recognition and enforcement of IP licensing relationships.[52] Further, the projects initiated by UNCITRAL to create a legal framework for initiating, maintaining, and concluding effective IP licensing transactions during bankruptcy have not assumed finality.[53] Unfortunately, the Indian judiciary has not had the opportunity to deal with issues of IP licensing in bankruptcy.[54] The resulting situation is 'a glaring gap in judicial and legislative guidance on the treatment of IP licenses in bankruptcy'.

While the IBC does not include a provision as exhausting and far-reaching as section 365 of the American Bankruptcy Code, multiple provisions in the Code harbour similar powers of rejection and avoidability. This part discusses those provisions and examines their scope considering their statutory construction and judicial guidance.

During liquidation

The IBC allows an Insolvency Trustee to disclaim onerous property.[55] Tracing its roots in English Bankruptcy Law,[56] the Trustee's disclaimer is the closest enunciation to an American bankrupt debtor's power of rejection.[57] A disclaimer effectively terminates the relationship between the parties and 'discharges the Bankruptcy Trustee from all personal liability in respect of the onerous property'.[58] It determines the 'rights, interests and liabilities of the bankrupt in respect of the onerous property disclaimed'.[59] Further, onerous property includes any unprofitable contract or any property which cannot be disposed off for value.[60] The provision to disclaim property is designed to avoid the financial incidence from maintenance of contracts that are unprofitable and can result in depletion of the pool of assets available to a bankrupt estate.[61]

The law on disclaimer originates from English Bankruptcy jurisprudence, and the statutory language employed by the two statutes is also identical.[62] Therefore, judicial decisions from the English jurisprudence should serve to determine the scope of the Indian provision as well. In 1997, the House of Lords opined the '*rights and obligations of these other persons (counterparty in a rejection) are to be affected as little as possible. They are to be affected only to the extent necessary to achieve the primary object: the release of the company from all liability*'.[63]

Applying this rationale to IP licenses should mean that a disclaimer would apply only to the extent of releasing the debtor from liability. It should not affect the foregoing interests of the licensee to continue using the licensed IP. However, given the lack of any judicial or administrative guidance on the issue, this conclusion can be very fragile.

During corporate insolvency resolution process

While 'disclaimer of onerous property' can be the closest enunciation to the American Bankruptcy Code's power to 'reject executory contracts', the two share an important difference. The power of disclaimer is limited to cases of liquidation and insolvency. It does not extend to cases of reorganisation or corporate insolvency resolution process (CIRP).[64] This section, therefore, turns to the CIRP and examines the extent up to which interference is warranted within IBC.

The IBC warrants avoidance powers for four 'vulnerable transactions': preferential transactions, undervalued transactions, transactions defrauding creditors and extortionate credit transactions.[65] Through avoidance of vulnerable transactions, *'the bankruptcy law allows the ex-post alignment the ex-post alignment of incentives between factually insolvency debtors and their creditors'*.[66] The power to avoid contracts allows a bankrupt debtor to reclaim the assets that a corporate debtor has surreptitiously distributed.[67] However, the avoidance powers apply in very specialised situations, and their application is limited by a curated set of procedural guidelines.[68] For example, if an undervalued or preferential transaction has been entered into in the ordinary course of business, it cannot be avoided.[69] All vulnerable transactions should have been concluded less than two years prior to the initiation of insolvency proceedings.[70] Therefore, the statutory guidelines which govern the applicability of avoidable transactions limit the applicability of the empowering provisions.

Apart from the maze of statutory guidelines and strict timelines,[71] the avoidance powers do not warrant review or rejection of commercial transactions that constitute fair and equitable business transactions. Deliberating on the scope of the avoidance provisions, the Indian Bankruptcy Law Reforms Committee noted that vulnerable transactions '*fall within the category of wrongful or fraudulent trading.... Or constitute unauthorised use of capital by the management*'.[72] The UK Supreme Court opined that the underlying policy of avoiding vulnerable transactions is '*to protect the general body of creditors against a diminution of the assets by a transaction which confers an unfair or improper advantage on the other party*'.[73] Explaining the scope of the avoidance powers, the Supreme Court of India opined that '*The IBC has made provisions for identifying, annulling or disregarding "avoidable transactions"* *which distressed companies may have undertaken to hamper recovery of creditors'*.[74] Hence, while avoidance powers may allow interference with pre-petition contracts, they are concerned with fraudulent transfers and providing fraudulent preference to a specific class of creditors. Hence, owing to the statutory design and legislative intention, avoidance powers cannot be comparable to the scope of section 365.

Another provision cited as enabling interference with pre-petition bankruptcy transactions is section 20(2)(b) of IBC.[75] The provision allows a Resolution Professional[76] or an Interim Resolution Professional to 'amend and modify' the terms of pre-petition contracts. However, judicial and administrative instruction dictates that the power incorporated in section 20(2)(b) cannot be exercised unilaterally. The National Company Law Tribunal (NCLT) Hyderabad in *EIH v. Subodh* explicitly noted that pre-petition contracts cannot be unilaterally amended or modified.[77] The NCLT Mumbai extended this rationale further and opined that even a resolution plan cannot alter legally valid pre-petition agreements. Pre-petition contractual obligations shall be conducted and disposed in the same manner as they would have been had insolvency proceedings not intervened.[78] Therefore, no unilateral amendments can be allowed within section 20 and thus, its mandate is not comparable with section 365 of the American Bankruptcy Code.

CONCLUSION

An examination of the treatment of IP licenses during insolvency reveals a curious deficiency under IBC. It omits any discussion about IP licenses and their relevance within insolvency. The legislature and administrative committees have overlooked an important interpretational guideline that can propose problematic domestic and cross-border insolvency conclusions. Examining the powers granted under IBC reveals that an insolvent debtor's ability to interfere with pre-petition contracts is very limited. The interpretation and application of these powers would not result in a situation as dire as the American Bankruptcy jurisprudence experienced with *Lubrizol* or *Qimonda*. However, this conclusion remains very fragile due to the lack of administrative, legislative or judicial guidance on the subject. What will happen if an Insolvency Trustee disclaims an exclusive IP license? In such a case, the exclusivity requirement will constitute a substantial impediment to the licensor's ability to monetise and exploit the subject IP right. Would the exclusivity requirement be frustrated with a disclaimer by the Trustee? To answer these questions coherently and identify the policy-based justifications for their application, the authors suggest that an administrative enquiry be conducted to eliminate the scope of speculation as to the treatment of IP licenses within IBC.

**This article has substantially drawn from authors' earlier two works: (1) Ram Mohan M. P. and Gupta A. (2021), "Treatment of Intellectual Property License in Insolvency: Analysing Indian law in comparison with the U.S. and U.K.", W. P. No. 2021-08-01, IIM-Ahmedabad Working Paper Series and (2) Ram Mohan M. P. and Gupta A. (2021), "Intellectual Property licenses in cross-border insolvency: Lessons from In Re Qimonda", WP 2021-11-05, IIM-Ahmedabad Working Paper Series.*

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