

CANADIAN BANKRUPTCY REPORTS

FIFTH SERIES / CINQUIÈME SÉRIE

RECUEIL DE JURISPRUDENCE CANADIENNE EN DROIT DE LA FAILLITE

Vol. 77 Part 2 August 2011 77 C.B.R. (5th) 175 – 344

ANNOTATIONS AND ARTICLES/ANNOTATIONS ET ARTICLES

Frajman, Daniel

Leases and Intellectual Property: Counter-Intuitive Amendments.....

CARSWELL®

Leases and Intellectual Property: Counter-Intuitive Amendments

Daniel Frajman*

The most recent volley of amendments to federal bankruptcy and insolvency law came into force on September 18, 2009. At least two of the new provisions (found in the *Bankruptcy and Insolvency Act* ("BIA"), with equivalent provisions also having been inserted at the same time in the *Companies' Creditors Arrangement Act* which can be used for restructurings where the debtor has more than \$5 million of debt) seem counter-intuitive in relation to general contractual or insolvency principles.

These two new provisions are s. 84.1 BIA, dealing with the assignment of agreements, apparently including commercial real estate leases, and s. 65.11(7) BIA, dealing with the use of intellectual property. As of yet, only s. 84.1 appears to have been subject to material judicial comment. The counter-intuitive aspect of s. 84.1 is that it seems to be a significant exception to the concepts of the binding nature and privity of contracts. As for s. 65.11(7), it appears counter-intuitive by upholding certain unsecured contractual rights notwithstanding an insolvency.

Assignment of Agreements

Section 84.1 states in part that "a court may make an order assigning the rights and obligations of a bankrupt under [an] agreement to any person". The apparent goal of this provision is to increase the value of a bankrupt's estate by treating its agreements, or contracts, as an asset that may be sold to a third party. The provision goes on to say that the factors to be considered for such an order are, among other things, whether the as-

*Daniel Frajman, a partner at the law firm of Spiegel Sohmer Inc. in Montreal, has written an article entitled, *Leases and Intellectual Property: Counter-Intuitive Amendments*. The article comments on two of the new provisions in the BIA and the CCAA dealing with the assignment of agreements, and the use of intellectual property. The author believes that the provisions concerning the assignment of agreements have begun to be commented upon by the courts.

signee "is able to perform the obligations", and "whether it is appropriate" for the assignment to take place.

Assignability under this provision is not available for certain contracts, notably agreements "that are not assignable by reason of their nature", and collective agreements. Also notable is s. 84.1(5), which further restricts the provision by indicating in part that the assignment order may not be made unless the court "is satisfied that all monetary defaults in relation to the agreement, other than those arising by reason only of the person's bankruptcy [or] insolvency, . . . will be remedied."

This provision clearly raises the possibility of a solvent party (that has entered into an agreement with the bankrupt) being unable to choose its debtor, and this notwithstanding that the solvent party otherwise benefits from a "consent clause" permitting it to withhold consent to an assignment when appropriate. An important question is whether this provision, given its above-mentioned text, applies to commercial real estate leases, and if so, its effect on such leases.

Although s. 84.1 does not apply to agreements not assignable by reason of their nature, commercial real estate leases (even those with a consent clause) likely are subject to the provision, given that an earlier exemption for commercial real estate leases was dropped in the final legislation. As to the effect of the provision on commercial real estate leases, in comparison with pre-existing provincial commercial lease legislation and case law dealing with lease transfers on a bankruptcy (under for example, s. 38(2) of the Ontario *Commercial Tenancies Act*, or article 1871 of the *Civil Code of Quebec* read with s. 30(1)(k) BIA), it may be that the bar for an assignee being approved has been lowered (i.e., a perceived "greater good" may override the landlord's interests), assignees may not have to abide by use clauses in the lease, and rental arrears, accelerated rent and penalties that may otherwise be due on a bankruptcy or insolvency may not be due in conjunction with the assignment.

Time will tell if, in particular, the courts allow s. 84.1 to override use and restrictive covenant clauses in leases (certainly it is in a commercial landlord's interest to draft such clauses as explicitly as possible), or if the provision will be challenged as an unconstitutional interference with provincial jurisdiction over property and civil rights. However, at least in Quebec, commercial landlords may be able to continue to avail (given a related provision, s. 84.2 BIA) of case law upholding lease clauses that deem a lease as resiliated upon a corporate tenant's bankruptcy.

The first material judicial comment dealing with s. 84.1 is worth noting, and appears to be that of the Alberta Court of Appeal in *Ford Credit Canada Ltd. v. Welcome Ford Sales Ltd.*, [2011] A.J. No. 592, 2011 ABCA 158, 2011 CarswellAlta 883 (Alta. C.A.), dealing with an automobile franchise agreement rather than a lease. The franchisor in this case (Ford) resisted assignment of the franchise agreement by the franchisee's bankruptcy trustee to an apparently solvent and experienced proposed assignee based on the franchisor's contractual right to withhold consent. The Court allowed the assignment based upon s. 84.1, and in so doing referred *inter alia* to the following:

- (a) The effect of s. 84.1 of the BIA is to override the common law unilateral right of the innocent party to the contract to accept the repudiation [by the defaulting party] and end the contract. [Section 84.1] has been designed to preserve the value of the estate as a whole, even if the contractual rights of some creditors, such as Ford in this case, are compromised.

[paragraph 30]

- (b) The estate of a bankrupt may include various forms of property. Sometimes the most valuable property in an estate will be the contractual rights possessed by the bankrupts of the date of bankruptcy. Those rights may be embodied in, for example, a franchise agreement, a purchase agreement, a license agreement, a *lease*, a supply agreement or an auto dealership agreement

[paragraph 38] (emphasis added)

- (c) the Court appeared to indicate that if a proposed assignee is appropriate, that influences whether the agreement is assignable by its nature, and a contractual statement that a debtor's rights are personal to it will not in itself be determinative.
- (d) The Court did however appear to regard as relevant that Ford's rights in this case as creditor under the contract would, notwithstanding the assignment, remain unchanged except for the change in identity of its co-contractant.

Intellectual Property

On a bankruptcy and insolvency, the claims of unsecured creditors rank last. The case law therefore seems to take the view that a trustee in bankruptcy can disclaim (or in Quebec terms, resiliate) a contract entered into by the bankrupt (including, arguably, intellectual property licenses granted by a bankrupt), subject to the co-contractant's right to an unsecured claim for damages. (In this regard, see *New Skeena Forest Products Inc., Re* (2005), 2005 BCCA 154, 2005 CarswellBC 578 (B.C. C.A.), at paras. 29 to 31.) In this vein, the recent BIA amendments, at s. 65.11, state in essence that in the event of an insolvency restructuring (i.e., the commercial debtor has filed a proposal or notice of intention to file a proposal), the debtor can have disclaimed or resiliated any agreement to which it is a party so long as, among other things, the disclaimer would enhance the viability of the proposal and would not likely cause significant financial hardship to the co-contractant. The provision provides for an unsecured damage claim in favour of the co-contractant.

By exception however, s. 65.11 is stated as not applying to certain contracts, such as collective agreements, financing agreements if the debtor is the borrower, and real estate leases if the debtor is the landlord. Furthermore, "rights of use" with regard to intellectual property are shielded from the debtor's right to disclaim/resiliate, as set out in s. 65.11(7) as follows: "If the debtor has granted a right to use intellectual property to a party to an agreement, the disclaimer or resiliation does not affect the party's right to use the intellectual property . . . during the term of the agreement, including any period for which the party extends the agreement as of right . . ."

Users of intellectual property that continue to meet their own obligations should therefore take note that even without the benefit of security, s. 65.11(7) allows them to uphold their rights of use (including any exclusivities) on an insolvency restructuring of the owner of the intellectual property. However, the provision does not seem to allow the user to force the licensor to continue on with service or development obligations. Although the terms "user" and "intellectual property" are not defined by the provision, licensees of copyrights, patents, trade-marks, and industrial designs seem to fall within the provision. Should however the insolvency restructuring fail and proceed to a bankruptcy, s. 65.11(7) would no longer apply, and the user of intellectual property would lose that specific statutory protection.

Objectives

Provisions such as ss. 84.1 and 65.11(7) BIA, counter-intuitive as they may be, are part of a set of amendments with stated objectives that include favouring the restructuring of viable businesses, and making the insolvency regime more fair. Time will tell how these objectives are addressed by the amendments generally, and by these two provisions in particular, and what further reforms might be necessary.

Daniel Frajman is a partner at the law firm of Spiegel Sohmer Inc. in Montreal, Quebec, and can be reached at dfrajman@spiegelsohmer.com. Daniel's practice includes a concentration on inter-provincial and cross-border matters.