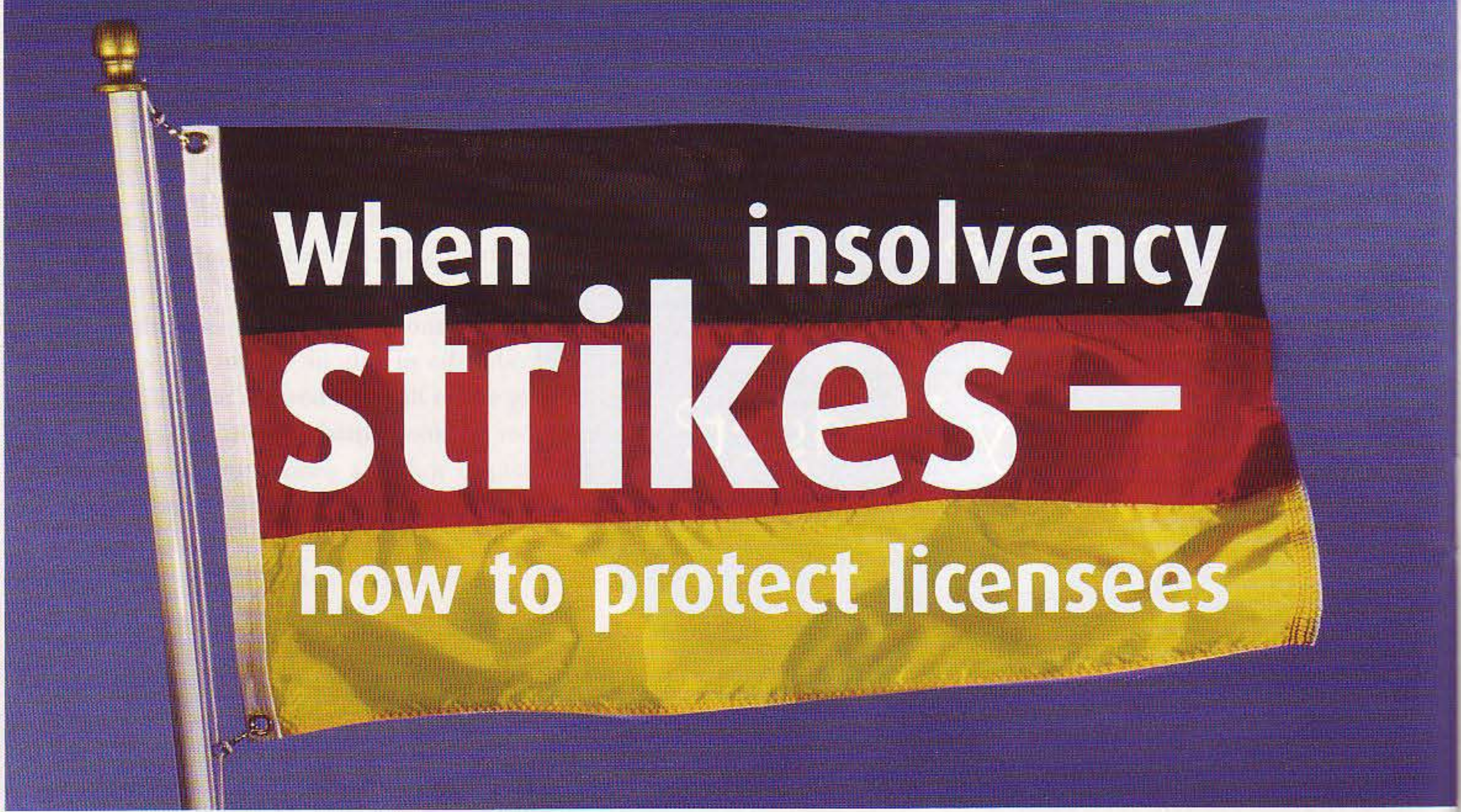

When insolvency strikes – how to protect licensees

Following recent revisions to Germany's legal system, the prospect of a company losing its patent licence in the event of a German licensor's insolvency is now a very real one. Dr Henning Mennenöh and Dr Markus Plesser outline ways of minimising that risk

Under German law, if a licensor becomes insolvent, the insolvency administrator is obliged to terminate the licence agreement if he is entitled to do so and if the existing licence agreement does not exploit the licensed patent on the best possible terms. Significantly, recent years have witnessed a change in the German legal framework governing this process. Until the end of 1998, the insolvency administrator could not terminate a licence agreement without the licensee's consent and as such, agreements were effectively 'insolvency proof'. However, in 1999, a new Insolvency Act came into force – it provided that, as a rule, the insolvency trustee can terminate licence agreements as long as neither party has completely fulfilled its obligations under them. This choice can only be exercised by the final insolvency trustee; the preliminary insolvency trustee has no such power.

For pharma and biotech companies, it is unclear whether this general rule for 'agreements' also applies to patent licences because these differ in many respects from ordinary agreements. The majority of authors in the legal literature, and court decisions relating to software licences, hold that the rule does also apply to patent licence agreements. So in light of the 1999 Act, this would mean that patent licence agreements are no longer insolvency-proof.

The change in the law affects all licence agreements in which the licensor is a German company and therefore subject to German insolvency law. This applies irrespective of the law governing the contract. For example, if a licensor is German, a clause stipulating that the licence agreement is governed by US law offers no protection to the licensee. German insolvency law applies without exception to all agreements concluded by a German licensor that subsequently becomes insolvent.

In light of these risks, the licensee should seek appropriate reassurance during the negotiation stage of the licence agreement and demand additional mechanisms to secure the licence in the event of the licensor later becoming insolvent. To this end, the literature proposes various different legal structures, although it is still unclear which of these mechanisms are actually insolvency-proof. No higher court, as yet, has issued any decision on these mechanisms, so the risks of the different approaches have to be weighed by the licensee before and during the contract negotiations. The four primary mechanisms currently under discussion relate to the licensor/licensee fulfilling their contractual obligations; the licensee making a pledge for the patent or assigning it to a third party; a trustee holding the licence in rem on behalf of both parties – a legal right relating to ownership of the licence (important because the location of the licence determines which court has jurisdiction); and a usufruct of the patent (the legal right to enjoy the profits), obligating the licensor to tolerate use of the patent.

Complete fulfilment of obligations

The German Insolvency Act allows the licensor to terminate an agreement in the event that neither the licensor nor the licensee have "completely fulfilled" their contractual obligations. Some authors argue that by granting the licence, the licensor has completely fulfilled its main obligation and that the insolvency trustee may therefore only terminate a licence agreement if the licensee has not yet completely fulfilled its obligation. They conclude that if the licensee has paid the licence fee in full in advance, it has completely fulfilled its obligations and that the insolvency trustee cannot terminate the agreement. Under this mechanism, the licensee can make the licence insolvency-proof by paying the entire licence fee in advance.

Unfortunately, the licensee cannot reasonably rely on this line of argument as it has already been rejected in a first decision at district court level. The weak point of this argument is that the licensor has more obligations than simply granting a licence, for example, it is also obliged to maintain a patent. It may thus be concluded that the licensor cannot 'completely' fulfil its obligations and that complete fulfilment by both parties can therefore not be achieved. As a consequence, the insolvency trustee would be entitled to terminate the licence agreement.

In addition, the complete fulfilment solution is incompatible with non-exclusive agreements which provide for ordinary termination rights, milestone payments and/or turnover-based licence fees. In these cases, the licensor cannot completely fulfil its obligations in advance. Furthermore, economic considerations will often prevent the licensee from agreeing to advance payments. Where the success of a drug is unpredictable, the drug manufacturer will be inclined to steer clear of high down-payments, preferring a combination of lump sum payments and turnover-based fees instead.

Pledge and assignment for security

Another proposal is that the licensee should safeguard the licence by demanding a lien on the patent or the assignment of the patent for security. Again, however, this model is not without its risks. Both the pledge option and the assignment for security only provide limited protection. It is unclear whether such safeguards would allow the licensee to use the patent in the event of the licensor's insolvency. The pledgee (licensee) could commercialise the patent in the event of the licence agreement being terminated, as a way of settling its claim for damages against the insolvency administrator. In theory, this could occur either through a sale of the patent to a third party, the grant of a licence to a third party or by the licensee using the patent itself. However, it is not clear whether the licensee actually has the right to this latter option – putting the patent to its own use – and only this alternative would lead to the desired result.

While some legal literature asserts that the pledgee may exploit the patent by using it, other authors reject this view. Accordingly, it is difficult to predict which side the courts are likely to come down on if this mechanism is used.

Double trust

A third proposal is the so-called 'double trust' model, in which the licensor grants the licensee an option for a perpetual licence *in rem*. This option is then transferred to a trustee who holds it on behalf of both parties to the licence agreement. In the event that the licensor becomes insolvent, the licensee can trigger the option. If the insolvency administrator refuses to perform and terminates the licence, the licence *in rem* held by the trustee secures the licensee's claim for damages against the insolvency administrator.

While case law confirms that the double trust model is insolvency-proof, it is not certain whether this solution allows the licensee to acquire the perpetual licence and use the patent. The option itself only gives the licensee a right to 'segregation', ie, the commercialisation of the licence separately from the other assets of the licensor, with the proceeds going to satisfy the licensee's claim for damages. But a right to segregation does not guarantee that the licensee may actually acquire the licence and use it itself – here, too, the licence has to be commercialised on the best possible terms. If a third party offers a higher price than the licensor is willing to pay, the licence must be sold to the third party.

A usufruct is an inalienable right to reap the fruits of something belonging to another – it would obligate the licensor to tolerate the use of the patent by the licensee

Usufruct of the patent

Several authors propose the creation of a usufruct (Lizenzsicherungsnießbrauch) on a patent as another way to protect the licensee. A usufruct is an inalienable right to reap the fruits of (or use) something belonging to another. In the case of patents, a usufruct would obligate the patentee (licensor) to tolerate the use of the patent by the usufructuary (licensee).

In the event of the licensor becoming insolvent, the licensor's assets are part of the bankrupt's estate. However, third parties may separate objects and rights which are not the property of the licensor. The insolvency administrator may not commercialise separated objects and rights to satisfy the creditors of the insolvency estate. Like third party property, usufructuary rights can also be separated. As a consequence, the insolvency administrator has to tolerate the usufruct for as long as it exists. And the usufructuary can use the patent despite the licensor's insolvency.

There are objections to this model, in particular, some authors question that the usufruct is more secure than a regular exclusive licence, although it appears many of them can be overcome. Indeed, convincing arguments indicate that a usufruct is, in fact, insolvency-proof. The grant of a usufruct creates a legal relationship in which rights and obligations are stipulated and which the insolvency trustee cannot terminate. Three legal relationships are to be distinguished:

- A licence agreement has to be concluded. The insolvency administrator may possibly terminate such an agreement.
- The parties conclude an agreement on the grant of a usufruct. As a rule, a usufruct would grant the unrestricted right to use the patent. The licensor may therefore demand a provision limiting the licensee's rights to use the patent and safeguarding its interest in securing the licence fees. Conceivable regulations include: limitation of the use of the patent to specific areas; automatic termination of the usufruct upon non-payment of the due fees (condition precedent); termination of the usufruct in the event that the licensee transfers the licence to a third party. A provision of this nature would ensure that both the usufruct and the licence agreement are always with the same party. It is in the licensor's interest to demand and push through effective and valid limitations.
- The usufruct has to be validly granted in fulfilment of the agreement on the usufruct. The grant of the usufruct will then remain effective even if the underlying contracts are invalid or terminated by the insolvency administrator.

It is necessary to bear in mind when evaluating this model that the questions and uncertainties surrounding it have not yet been fully clarified. Thus, case law on this model and the relating issues should be monitored closely.

Every case is different

Various models have been proposed to ensure the survival of patent licences in the event of German licensors becoming insolvent. The higher courts have not yet confirmed that any of the models described actually protect the licensee. On balance, the usufruct model seems to offer the best available protection but it will not be suitable in all cases. Companies which are considering entering into patent licence agreements therefore have to weigh up which model best meets their requirements on a case by case basis, and in the absence of higher court decisions, the best course of action is to keep a close eye on case law as it develops.

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