

COMMENTS

THE INTELLECTUAL PROPERTY BANKRUPTCY PROTECTION ACT: AN UNBALANCED SOLUTION TO THE INTERNATIONAL SOFTWARE LICENSING DILEMMA

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1. INTRODUCTION

The United States' technological leadership in the world marketplace has gradually eroded within the last two decades,¹ prompting increased efforts towards the development of new strategies to maintain U.S. competitiveness.² The United States' comparative advantage has notably slipped in industries such as microelectronics and optical communications.³ However, it remains highly competitive in knowledge-

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¹ See generally Llana, *Is Our Telecom Infrastructure on the Block?* NETWORK WORLD, Jan. 9, 1989, at 32; Andrews, *A Foreign Push for U.S. Patents*, N.Y. Times, June 4, 1989, § 3, at 4, col. 2.

² *Communications and Computers in the 21st Century: Hearing Before the Technology Policy Task Force of the Comm. on Science, Space, and Technology*, 100th Cong., 1st Sess. 10 (1987) (statement of Richard Nelson, Henry R. Luce Professor of International Political Economics, School of International Public Affairs, Columbia University) [hereinafter *Communications and Computers in the 21st Century*]. See also *Technology and Economics in a Shrinking World: Hearing Before the Technology Task Force of the Comm. on Science, Space, and Technology*, 100th Cong., 1st Sess. (1987) [hereinafter *Technology and Economics in a Shrinking World*]; *Small Business and High Technology: Hearing Before the Subcomm. on General Oversight and the Economy of the Comm. on Small Business*, 99th Cong., 2d Sess. (1986); OFFICE OF TECHNOLOGY ASSESSMENT, INTERNATIONAL COMPETITION IN SERVICES 17 (1987) [hereinafter INTERNATIONAL COMPETITION IN SERVICES].

³ *Communications and Computers in the 21st Century*, *supra* note 2, at 27 (testimony of Larry W. Sumney, President, Semiconductor Research Corporation); Betts, *High-Tech a Non-Issue in '88*, COMPUTERWORLD, Nov. 7, 1988, at 155. While there is no single cause for the general decline of U.S. international competitiveness in various industries, it has been posited that structural changes in the world economy, resulting in large part from postwar U.S. foreign policy, have played a primary role in that decline.

One of the major objectives of U.S. foreign economic policy during the postwar period has been to help other nations, including lesser developed countries, build up

based sectors such as computer software,⁴ which has been targeted as one of several industries having the greatest potential impact on U.S. international competitiveness.⁵

Increased dependency upon and demand for computer products has sparked a rapidly growing interest in this industry worldwide. Developing countries such as Singapore and Taiwan have begun to emphasize software development in their programs for technological progress, while industrialized nations such as West Germany have shifted government research funding from hardware to software.⁶ Nonetheless, the United States remains the undisputed world leader in software de-

their economies and develop technologically. For instance, in the 1950s the transfer of U.S. technology through heavy direct investment helped Europe rebuild, while during the 1970s South Korean construction companies learned their trade in Vietnam or the Middle East, where they worked with U.S. firms. In less than 10 years, South Korean exports of these services grew phenomenally, from \$83 million in 1972 to almost \$14 billion by 1981. *Technology and Economics in a Shrinking World*, *supra* note 2, at 28 (statement of John A. Alic, Senior Associate, Office of Technology Assessment). U.S. technological assistance promoted increased technical competence in other countries, while simultaneously altering its competitive position with foreign firms. U.S. firms subsequently found themselves in a more international and open trading market in which it has become more difficult to compete.

⁴ Computer products are broadly classified in two categories, hardware and software. Computer hardware refers to the physical machinery, i.e., the computer terminal and keyboard, whereas software refers to the machine-readable programs that instruct the computer to perform functions for the user. Davidson, *Protecting Computer Software: A Comprehensive Analysis*, 23 JURIMETRICS J. 337, 340 n.1 (1983).

Computer hardware has become less important as a target of development than software. This is due, in part, to the enormous cost-cutting potential and strategic applications available for software users, as well as the possibility of "multiplying the productivity increments in industries not currently served by software applications." INTERNATIONAL COMPETITION IN SERVICES, *supra* note 2, at 17. In addition, there is the growing awareness that "U.S. competitiveness in computer hardware, and indeed in all high-technology industries, increasingly depends on software." *Id.* (italics omitted). Computer hardware technology "[has] developed greatly through advances in semiconductor technology which are little short of phenomenal; but what the hardware can do depends on the software. It seems that a 'software age' has dawned, and that there is little prospect for future development without software strength." Hirakawa, *Software Agreement Signed Between IBM and Two Compatible Machine Builders*, INDUSTRIAL REVIEW OF JAPAN 1984 56 [hereinafter *Software Agreement Signed*].

Due to the current downward trend of the U.S. economy and the falling dollar, financial analysts diverge in their predictions on how technology, i.e., computer hardware, concerns will fare. While the profit margins of even the leaders could suffer, the larger software developers, such as Microsoft, a maker of "sophisticated operating software," are viewed by some as "recession-proof" since "[e]very new or old IBM machine will have to have its software." Sandler, *Outlook for Technology Stocks in 1988 Causes Bewilderment and Analyses Aren't Much Help*, Wall St. J., Dec. 31, 1987, at 31, col. 2.

⁵ INTERNATIONAL COMPETITION IN SERVICES, *supra* note 2, at 17. U.S. firms are also highly competitive in the fields of telecommunications, data processing and information services. *Id.* at 16. See also Rifkin, *Software Is the Next Target*, N.Y. Times, Oct. 15, 1989, § 3, at 2, col. 2.

⁶ *Id.* at 17.

velopment. Statistics indicate that U.S.-based firms controlled about seventy percent of the world software market in 1985, earning some twenty-one billion dollars in revenues.⁷ It is predicted, however, that this lead will inevitably narrow as Japan seeks to develop software applications⁸ that will enable its computer manufacturers to more effectively penetrate world markets.⁹

⁷ OFFICE OF TECHNOLOGY ASSESSMENT, TECHNOLOGY AND THE AMERICAN ECONOMIC TRANSITION: CHOICES FOR THE FUTURE 333 (1988) [hereinafter TECHNOLOGY AND THE AMERICAN ECONOMIC TRANSITION].

⁸ Earlier this decade, it was thought that Japanese software developers lacked the requisite expertise to develop software "in the same profusion as it [was] being developed in the United States." Note, *Protections for Software Under U.S. and Japanese Law: A Comparative Analysis*, 7 B.C. INT'L & COMP. L. REV. 353, 555-56 (1984) [hereinafter *Protections for Software*]. As one commentator explained, this may have been due to a language barrier; since "most programming languages such as COBOL do not readily lend themselves to translation into Japanese, . . . in order to become proficient programmers, Japanese software developers must first be fluent speakers of English." *Id.* n.20 (citing Yoshio, *Technological Transfer: Grafted or Potted*, 7 JAPAN ECHO 25 (1980)).

The surge of Japanese activity in this area indicates that this "setback" is no longer a hindrance. For instance, in 1983, two of Japan's major manufacturers, Fujitsu, Ltd. and Hitachi, Ltd., entered into an agreement to "restrict business activities of the two companies as they [had] been expanding their shares of the domestic market by manufacturing IBM-compatible machines which could use application software originally designed for IBM equipment." *Software Agreement Signed*, *supra* note 4, at 56. Since then, numerous disputes have arisen between U.S. and Japanese software manufacturers for various forms of infringement, indicating Japan's rapid advancement in the industry. See Miller, *U.S. Software Firms Complain Fujitsu Gained Edge in IBM Copyright Decision*, Wall St. J., Oct. 7, 1987, at 4, col. 2.

In fact, Japanese advancement has so progressed that reciprocating licenses issued from Japanese software manufacturers to U.S. companies and alliances with Japanese firms are now highly sought after by U.S. firms. See Rehfeld, *Forming Global Alliances*, PERSONAL COMPUTING, Oct. 1988, at 292; *Reduced Trade Tensions Sought*, Wash. Post, Aug. 1, 1985, at E1, col. 2.

⁹ INTERNATIONAL COMPETITION IN SERVICES, *supra* note 2, at 17. See also TECHNOLOGY AND THE AMERICAN ECONOMIC TRANSITION, *supra* note 7, at 333. Although European firms currently have the second most competitive software industry after the United States, a more significant threat is seen as coming from across the Pacific, with Japan in the forefront. *Id.* See also Ruhl, *MCC and Other Research Clubs: Do They Work?*, ELECTRONIC BUSINESS, Dec. 10, 1988, at 17. The National Research Council cautions that the United States "cannot afford to be complacent about its computer technology strengths . . . on an assumption of an invincible lead," noting that "as the computer market becomes increasingly global, U.S. firms face increasing foreign competition." *U.S. Advised to Revamp Export Curbs*, L.A. Times, Dec. 30, 1988, § 4, at 2, col. 1.

Japan has already clearly demonstrated its ability in manufacturing industries. It is believed that Japanese improvement in services such as software "will follow, if at first only to meet Japan's own needs and to take advantage of the "country's expanding hardware base." INTERNATIONAL COMPETITION IN SERVICES, *supra* note 2, at 7-8.

Another advantage favoring Japan is the fact that its government is "more attuned than those of Western governments to the needs and consequences of the shift toward an information-centered economy." *Id.* at 8-9. Government officials are working on moving the Japanese economy away from an emphasis on the manufacture of consumer durables to a focus on knowledge-based technology services. *Id.*

According to a recent study by the U.S. Office of Technology Assessment, continued U.S. competitiveness will depend upon changes in U.S. technology policy, beginning with a shift in attitude toward foreign know-how.¹⁰ The United States no longer occupies a seat as the primary technology source for the rest of the world, as the sophistication of foreign technology often matches that of the United States. It can, in fact, now learn from the other nations. Technology transfers, which are most commonly conducted through the highly favored licensing mechanism,¹¹ will necessarily become more reciprocal as U.S. companies seek to achieve a "more balanced two-way flow" by becoming "more aggressive in locating and acquiring foreign know-how[.]"¹²

Recent years, however, have seen what some perceived to be a threat to the continued viability of software and other forms of technology licensing in the United States. Despite U.S. leadership in software development, wary industry leaders feared the loss of this position as a result of the ambiguous application of the U.S. bankruptcy laws to software licensing agreements.¹³ Section 365 of the Bankruptcy Code¹⁴ allows a trustee or debtor-in-possession¹⁵ of a bankrupt estate to reject executory contracts¹⁶ such as software licenses. Upon rejection, the licensed material reverts to the debtor and becomes property of the es-

Lastly, steady increases in direct investment abroad by Japan, no doubt spurred on by the appreciation of the yen against other currencies, will serve to facilitate Japanese access to U.S. and European software technologies. Statistics indicate that the value of Japanese investment abroad remained consistently below \$1 billion until 1971, increasing sharply thereafter. Between 1972 and 1980, direct investment abroad averaged between \$2.3 to \$5 billion. Between 1981 and 1985, investment averaged between \$7.7 and \$12.2 billion, passing the \$10 billion point for the first time in 1984. Finally, in 1986, the annual value of investment abroad was recorded at over \$20 billion. Tsukazaki, *Japanese Direct Investment Abroad*, J. OF JAPANESE TRADE & INDUS. (No. 4 1987) at 10.

¹⁰ INTERNATIONAL COMPETITION IN SERVICES, *supra* note 2, at 18-19. See also *Technology And Economics in a Shrinking World*, *supra* note 2, at 29 (statement of John A. Alic, Senior Associate, Office of Technology Assessment).

¹¹ See *infra* notes 23-35 and accompanying text.

¹² INTERNATIONAL COMPETITION IN SERVICES, *supra* note 2, at 18-19 (emphasis added).

¹³ See *infra* text accompanying notes 36-57.

¹⁴ 11 U.S.C. § 365 (1982).

¹⁵ A trustee is normally assigned in a Chapter 7 (liquidation) bankruptcy to administer the bankrupt estate by collecting and reducing property of the estate to cash and making distributions to creditors as provided in 11 U.S.C. §§ 507, 726 (1982). In a Chapter 11 (reorganization) bankruptcy, the company or partnership is "preserved as a going business concern." Drabkin & Brooks, *Special Problems in Computer Industry Bankruptcies and Workouts*, in 1987 LICENSING LAW HANDBOOK: COMPUTER SOFTWARE DISTRIBUTION & ACQUISITION ISSUE, 12-1, 12-26 (D.C. Toedt, 3d ed. 1987) [hereinafter Drabkin]. In a Chapter 11 proceeding, the licensor/debtor-in-possession is accorded protection under the bankruptcy laws from creditors while it organizes a plan for the reorganization of its affairs. *Id.*

¹⁶ See *infra* text accompanying notes 58-89.

tate.¹⁷ Where the debtor is licensor, rejection could have a potentially detrimental effect upon the licensee's business if the licensee is deprived of continued use of the program. This is particularly true if its profits stem solely from the use of the licensed material.¹⁸ Although an injured licensee can recover monetary damages, they are usually inadequate compensation for the ruin of a profitable enterprise.¹⁹

In the seminal 1985 case, *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*,²⁰ the Fourth Circuit affirmed a trustee's power to reject a technology license where the trustee demonstrates that, in his business judgment, continuation of the agreement would not benefit the debtor-licensor's estate. The court's holding and the potential of further erosion of U.S. competitiveness created an outcry among technology industry leaders who viewed the decision as "threat[ing] an end to the system of licensing of intellectual property . . . that has evolved over many years to the mutual benefit of both the licensor and licensee and to the country's indirect benefits."²¹ Because the ambiguity provided U.S. licensees no assurance of the continued use of the license in the event of licensor bankruptcy, the high-tech industry envisioned a potentially chilling effect upon licensing activity with both domestic and foreign licensees.

The potential of further disruption to the valuable technology licensing system prompted a coalition of industry leaders, led by the

¹⁷ 11 U.S.C. § 541(a) (1982). Under § 541(a), an estate is automatically created upon the filing of a petition in bankruptcy. Property of the estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1). See also HOUSE COMM. ON THE JUDICIARY, BANKRUPTCY AND INTELLECTUAL PROPERTY AMENDMENTS, H.R. REP. NO. 1012, 100th Cong., 2d Sess. 3 (1988) [hereinafter H.R. REP. NO. 1012].

¹⁸ The range of licensing transactions vary greatly. However, there are two common arrangements. First, a licensor may license out an applications software package that controls daily business functions of the licensee's operation such as payroll, accounting, production and inventory. Conley & Bryan, *Software Escrow in Bankruptcy: An International Perspective*, 10 N.C. J. INT'L & COM. REG. 579, 579 (1985) [hereinafter Conley]. Second, a licensor may license out an idea in the form of object code, allowing the licensee to develop its own product using the object code as a basis for its invention. Note, *Rejection of Computer Software Licensing Agreements in Bankruptcy*, 8 CARDOZO L. REV. 361, 364 (1986) [hereinafter *Rejection of Computer Software*].

¹⁹ 11 U.S.C. § 365(g) (1982). After a contract is rejected, the licensee can file for damages as a general unsecured creditor. Monetary damages, however, may not adequately compensate for losses suffered as a result of rejection because they will be paid at the same pro-rata level as payments made to the other general unsecured creditors. See *Rejection of Computer Software*, *supra* note 18, at 380-81.

²⁰ 756 F.2d 1043 (4th Cir. 1985), *cert. denied sub nom.* Lubrizol Enterprises, Inc. v. Canfield, 475 U.S. 1057 (1986).

²¹ SENATE COMM. ON THE JUDICIARY, INTELLECTUAL PROPERTY BANKRUPTCY PROTECTION ACT, S. REP. NO. 505, 100th Cong., 2d Sess. 3 (1988) [hereinafter S. REP. NO. 505].

computer industry, to persuade Congress to amend section 365 of the Bankruptcy Code. The Intellectual Property Bankruptcy Protection Act was signed into law on October 18, 1988. The Act amends section 365 by adding a new provision, section 365(n), which specifically addresses technology licenses in bankruptcy.

While the concerns that prompted the amendment of section 365 were not unfounded, the industry fears which led to this response may have been premature. This Comment considers the potential effects of section 365(n) on the software licensing mechanism. Part 2 will present a brief overview of software licensing.²² Part 3 will discuss the historical treatment of executory contracts under section 365 of the Bankruptcy Code. This is followed by a brief survey of the judicial treatment of executory software/technology licenses in Part 4, which questions the immediacy of the threat posed by *Lubrizol*. In Part 5, the legislative background and provisions of section 365(n) are described. Part 6 analyzes the amendment, discussing its general effects and international business implications. Part 7 concludes that section 365(n) may not have been the ideal solution because it is unbalanced and overcompensates for the inequities that existed in the system. As a result, section 365(n) could have the potential chilling effect on software licensing it sought to avoid and do little to enhance U.S. competitiveness worldwide.

2. OVERVIEW: THE SOFTWARE LICENSING DILEMMA

2.1 *Why License?*

Of the methods by which technology may be transferred, licensing provides the most agreeable mechanism for the parties involved and maximizes the widespread use of intellectual property. It is a highly favored method of accessing international markets,²³ particularly by

²² Although this Comment deals specifically with software licenses, the concepts discussed are similarly applicable to other types of technology licenses.

²³ Some of the reasons businesses have entered foreign licensing agreements are:

(1) Licensing permits entry into foreign markets without large capital outlays. It is, therefore, a favorite device for small and medium-sized companies.

(2) Returns are apt to be more rapidly realized than in the case of manufacturing ventures.

(3) The income from foreign licensing helps to underwrite costly research programs.

(4) Licensing enables a firm to retain markets otherwise lost by import restrictions or because it is being outpriced.

(5) Licensing can be used to test a foreign market and then to service it without costly additions to production or detracting from the supply

small and mid-sized companies, because it does not require large capital outlays from the licensor and avoids the complications that can arise from either exporting or direct investment.²⁴

Creators of new technology are often individuals or small businesses that do not possess the capital to fully develop and market an idea, an expensive process that must proceed through a "risky series of steps including research, development, manufacturing and marketing."²⁵ Even the most established firms with superior manufacturing capabilities and large capital bases, however, cannot develop all the best ideas on their own. Often it is those "working alone at night in their garages or living room [who] come up with some of the best [ideas]."²⁶

One method by which firms can obtain new technology is by purchasing outright from its creator. This option has several drawbacks. First, because firms will necessarily have to assume all the risks involved with incorporating the idea into a product, they will not be willing to pay a high price²⁷ for an idea that may go nowhere.²⁸ Second, creators may be reluctant to sell their idea if it is their most valua-

available for local customers.

(6) Licensing permits a company to develop outlets for components of other products and to build goodwill for other company products.

(7) Licensing enables a company to establish an operation in countries that will not permit the establishment of a local subsidiary controlled by foreigners.

(8) Licensing is a two-way street which may permit the American company to get access to a foreign company's technology and even acquire a whole new product line without the delay and expense of development.

Travaglini, *Foreign Licensing and Joint Venture Arrangements*, 4 N.C. J. INT'L L. & COM. REG. 159, 159-60 (1979). See also Mirabito, *Technology Transfers of Patent/ Data Rights in the Commercial Sector: A Primer*, 7 B.C. INT'L & COMP. L. REV. 251, 255 (1984).

²⁴ Travaglini, *supra* note 23, at 159. For instance, difficulties involving trade barriers, transportation costs and product design or distribution can arise when exporting. *Id.* Direct investment, once a popular form of investment abroad, is no longer ideal due to the increasing reluctance of foreign governments to permit the establishment of wholly-foreign-owned plants in their countries. *Technology and Economics in a Shrinking World*, *supra* note 2, at 24 (statement of John A. Alic, Senior Associate, Office of Technology Assessment). Direct investment also requires a commitment of capital that a company may not be able nor wish to make.

²⁵ S. REP. NO. 505, *supra* note 21, at 3.

²⁶ *Intellectual Property Contracts in Bankruptcy: Hearing on H.R. 4657 before the Subcomm. on Monopolies and Commercial Law of the House Comm. on the Judiciary*, 100th Cong., 2d Sess. 18 (1988) (testimony of James Burger, Chief Counsel, Apple Computer, Inc.) [hereinafter *H.R. 4657*].

²⁷ Outright sale is also an unattractive option for licensees who may want "to exploit the intellectual property in only a single field of use, and [are] unwilling or unable to pay a higher price to obtain the right for all fields of use." *Id.* at 84 (statement of Harry F. Manbeck, Intellectual Property Owners, Inc.).

²⁸ *Id.* at 20 (testimony of James Burger).

ble asset.²⁹ Those who do choose to sell their ideas part with ownership of them. This not only deprives the creator of any further control over the disposition of his invention, but greatly minimizes the financial rewards he can potentially reap. Third, outright sale can prevent the efficient use of intellectual property by restricting the number of parties who can develop the idea in other fields of use.³⁰

Another method of obtaining new ideas is through an assignment. An assignment transfers all of the creator/assignor's rights in the idea or invention to the firm/assignee. It grants a proprietary interest in the idea "sufficient to allow the [assignee] to sue a third party infringer in the [assignee's] own name" for the term of the assignment.³¹ This arrangement is akin to a temporary sale; the assignee essentially "owns" the invention for the assignment's term, and the assignor is "either totally alienated from his creation or, at best, given a license by the assignee."³² The inherent drawbacks to this approach, which are similar to those associated with outright sales, are seen as creating a disincentive for licensors and the development of intellectual property.³³

The licensing mechanism allows both parties to benefit. The creator can test the value of his idea and share the risks and rewards with the firm providing the funding and refinement necessary to produce an economically successful product.³⁴ At the same time, the creator retains control over and ownership of the idea. Licensing also enables the creator to make the most efficient use of his idea by leasing it out in as many geographical areas or fields of use for which there are applications.³⁵

2.2 The Software Licensing Framework

In the basic software licensing arrangement, whether foreign or domestic, the licensor grants the licensee the right to use software for a limited time period.³⁶ The licensee's right of use may be exclusive or

²⁹ *Id.* at 84 (statement of Harry F. Manbeck).

³⁰ S. REP. NO. 505, *supra* note 21, at 4.

³¹ Tamietti, *Technology Licenses Under The Bankruptcy Code: A Licensee's Mine Field*, 62 AM. BANKR. L.J. 295, 302 (1988). For a detailed discussion of technology assignments and their recovery in bankruptcy, see *id.* at 303-10.

³² S. REP. NO. 505, *supra* note 21, at 4.

³³ *Id.*

³⁴ *Id.* at 3.

³⁵ *Id.*

³⁶ Licensing arrangements will differ depending on the nature of the material leased out. Generally, there are three techniques in which software is licensed: mass marketing; large markets with continuing services; and custom servicing. Each involves a different type of software. *Rejection of Computer Software*, *supra* note 18, at 366-74. Ordinary off-the-shelf sales in a retail store are an example of mass marketing.

non-exclusive.³⁷ In exchange, the licensor receives a set fee or a negotiated percentage of the licensee's profits that derive from the use of the licensed software.³⁸ Each party must continue to perform its respective obligatory duty,³⁹ which is laid out in the license agreement, for the

Software marketed in this manner is widely available to the general public. Most software packages include a standard license "which purports to retain ownership in the developer, granting to the purchaser only certain rights of use" on the packaging, in the instructions and/or on the diskette itself. *Id.* at 366. Despite the presence of the printed licenses, it is very difficult for the licensor to retain control over the product due to the volume at which mass marketed software is produced and sold to the general public. It would thus be uneconomical and administratively burdensome to monitor for infringing users.

The large markets with continuing services category also involves large numbers of licensed users. This category includes standardized software for activities such as business accounting, which require minimum adaptations to suit the specific needs of a particular licensee's business. *Id.* at 368. These licenses may include complex contractual arrangements which include a variety of duties required by both licensor and licensee. While there is a sufficient degree of obligation in this type of arrangement for the contract to qualify as an executory contract, it is probably not to the licensor's benefit to reject the license in bankruptcy due to the large number of licensees using the same or a similar program. *Id.* at 370-71.

Customized software is created to accommodate the unique needs of the licensee. Often, the licensee is the only one who is using the program. A special program designed to control an aircraft's auto-pilot is one example of customized software. *Id.* at 371. The contractual arrangements are the same as those for standardized software, but the risks to the licensee in the event of rejection in a bankruptcy proceeding are substantially greater. The licensee's business will undoubtedly be dependent upon the use of the software and it will be difficult for it to find an immediate replacement due to the software's exclusive nature. *Id.*

³⁷ A licensee with an exclusive license has the right to use the licensed material to the exclusion of all others, including the licensor himself. A less harsh option for the licensor, with a lower standard of exclusivity, is one that grants the licensee the right to exclude all persons from using the licensed intellectual property, with the exception of the licensor. These licenses may be referred to as sole licenses. Lastly, a more common arrangement is the non-exclusive license, which gives the licensee a right to use licensed property, but no right to exclude others from using it. Wiesen, *The Elements of a Domestic License of Intellectual Property*, in 9 A.L.I.-A.B.A. COURSE MATERIALS J. 55, 56 (1984).

³⁸ For a more detailed discussion of these royalty arrangements, see *id.* at 63-67.

³⁹ Obligatory duties are laid out in the contractual agreement along with the usual elements of a licensing contract, including: provisions for its duration; grants of rights to use, manufacture, and distribute the product or a product whose creation was based on the use of the licensed material; and protection of rights that are subject to license, grantback, or cross-licensing provisions. Travaglini, *supra* note 23, at 161-69. Obligations that commonly appear in licensing contracts include:

- covenants not to compete;
- agreements to refrain from raiding key employees;
- agreements not to reveal trade secrets acquired during the contractual period;
- agreements to indemnify users against patent and copyright infringements;
- agreements limiting the copies to be made;
- agreements to pay royalties;
- agreements to provide maintenance.

Drabkin, *supra* note 15.

Due to their international scope, foreign licensing agreements include many ele-

term of the license.⁴⁰ In this type of arrangement, the licensor will usually distribute only the software program's object code to the licensee and retain ownership of the source code.⁴¹

This arrangement places the licensee in an extremely vulnerable position. Since the object code is unintelligible to the ordinary user, it does not provide information regarding the program's nature. A licensee must therefore have access to the source code as well as the object code in order to understand how the program runs. Access would be particularly beneficial should an emergency, such as licensor bankruptcy, arise because access would allow the licensee to provide for

ments which may be absent in domestic licenses such as choice of law, currency control, and arbitration provisions. Travaglini, *supra* note 23, at 164. In an attempt to ensure compliance with their standards, U.S. licensors may also require, through contractual provision, the foreign licensee to allow access, test, and inspection rights at its facilities. *Id.* It is not unusual to require licensees to provide the licensor with a sample of any new product so that it may be inspected before it is manufactured and publicly distributed. *Id.*

Unlike licensing transactions which take place within the United States, it is difficult for a U.S. licensor to monitor and control the quality of the licensee's product. A licensor may have an interest in monitoring the licensee's activities involving the licensed material in order to protect his idea, product, or company's reputation. Thus, licensing arrangements which involve parties based in another country often require that any products derived from the licensed material "meet [the licensor's] standards of quality and performance." *Id.* Defects or low-quality could potentially cause damage to the licensor's reputation if the licensee's product becomes associated with the licensor. Competition presents another problem. The danger here is "once a licensee has acquired technical proficiency and a good market, pressure can build to terminate the license or at least to revise it to the licensor's detriment." *Id.* at 160.

⁴⁰ While there are many possible variations to this basic scheme, this Comment focuses only upon licensing arrangements which involve an active and continuous relationship between the licensor and licensee as a result of contractual obligatory duties.

⁴¹ Computer programs are composed of source code and object code. The source code is "the series of instructions to the computer program for carrying out the various tasks which are performed by the program . . ." SAS Inst., Inc. v. S & H Computer Sys., Inc., 605 F. Supp. 816, 818 (M.D. Tenn. 1985). It is through the use of the source code that software programs are written. The source code can be written in a language similar to English which is generally understandable to those literate in computer languages. *Id.* It can also be written without English, in symbolic language. Davidson, *supra* note 4, at 341. Examples of English-equivalent computer languages are BASIC and FORTRAN. SPL or direct machine language, on the other hand, consists entirely of ones and zeros exemplifying symbolic language.

Programs written in source code must first be converted into object code by a separate program called a "compiler" before a computer can carry out the instructions it receives. See Apple Computer, Inc. v. Franklin Computer Corp., 714 F.2d 1240, 1243 (3d Cir. 1983). The object code is stored on a memory device such as a floppy disk, and is what a software purchaser receives. It facilitates the program's execution and deters undesirable (from the developer's viewpoint) modifications by adventurous buyers. Note, *Defining the Scope of Copyright Protection for Computer Software*, 38 STAN. L. REV. 497, 502 (1986). It is unintelligible to the ordinary user and cannot provide him with any information concerning the nature of the program. Only the source code can be of assistance to a user interested in discovering how the program runs. Conley, *supra* note 18, at 581.

himself any maintenance functions (i.e., debugging and updating)⁴² that were originally the licensor's responsibility under the licensing agreement.⁴³ However, since licensors retain the source code, only they can continue to properly maintain the software.⁴⁴

Software licensors are reluctant to distribute the source code because it provides the key to deciphering, and potentially misappropriating, the original program.⁴⁵ While the creation of a complex and innovative software program requires substantial investments of time and money, it takes only a fraction of this time and money to copy a program.⁴⁶ Herein lies the danger. The source code enables a licensee to copy the original program and possibly escape retribution from the licensor by adding a sufficient number of changes to the new program to disguise the copying.⁴⁷ Even if the licensee only uses the licensor's

⁴² Software is improved and enhanced periodically because it is easily adaptable and modifiable. Unlike hardware maintenance, which involves replacing defective parts and servicing in order to return the hardware to its original level of functionality, software maintenance adds new capabilities. Martin & Deasy, *Licensing of Intellectual Property Rights Needed for Software Support: A Life Cycle Approach*, 28 JURIMETRICS J. 223, 225 (1988). Thorough maintenance consists of three separate functions: 1) corrective maintenance, which aims to correct errors in the software; this is also known as debugging; 2) perfective maintenance, which improves the software to respond to new user needs; and 3) adaptive maintenance, which changes the software, enabling it to operate on a new operating system or on new hardware. *Id.* (citing B. P. LIENTZ & E. B. SWANSON, SOFTWARE MAINTENANCE MANAGEMENT 68 (1980)).

⁴³ Conley, *supra* note 18, at 581.

⁴⁴ Raysman & Brown, *Source Code Escrow Agreements*, N.Y.L.J., Jan. 10, 1984, at 1, col. 1.

⁴⁵ One commentator points out that the reluctance to distribute the source code to licensees is a recent development. While the source code was freely distributed in the beginning of the computer age "without any retention of intellectual property rights in an effort to promote hardware sales . . . , [this changed] as the cost of hardware . . . declined dramatically, [and] enormous investments [were] made in software development." Conley, *supra* note 18, at 581 n.10.

⁴⁶ Davidson, *supra* note 4, at 339. See also *Rejection of Computer Software*, *supra* note 18, at 362.

⁴⁷ Conley, *supra* note 18, at 581-82. Computer programs have been extended protection under U.S. copyright law since 1980. See 17 U.S.C. §§ 101, 102, 117 (1982). See also *Apple Computer, Inc. v. Formula Int'l, Inc.*, 725 F.2d 521, 523 (9th Cir. 1984); *Apple Computer, Inc. v. Franklin Computer Corp.*, 714 F.2d 1240, 1247-55 (3d Cir. 1983). However, a copyright will only protect a work's (or a computer program's) expression, and "in no case does copyright protection . . . extend to any idea, procedure, process, system, method of operation, concept, principle, or discovery, regardless of the form in which it is described, explained, illustrated, or embodied in such work." 17 U.S.C. § 102(b). Courts have long maintained this idea/expression distinction in a variety of contexts. See, e.g., *Baker v. Selden*, 101 U.S. 99, 100-01 (1879) (accounting system held protected under copyright law where alleged infringer used original author's idea but expressed that idea in a different manner); *Mattel, Inc. v. Arzak-Hamway Int'l, Inc.*, 724 F.2d 357, 358-60 (2d Cir. 1983) (superhero dolls protected since superhuman form is merely an idea and allegedly infringing dolls emphasized muscle groups different from those accentuated in originals); *Continental Casualty Co. v. Beardsley*, 253 F.2d 702, 705 (2d Cir. 1958), *cert. denied*, 358 U.S. 816 (1958)

"ideas, concepts, and programming methods for use in preparing a competing program, the source code will be an invaluable reference material."⁴⁸ Although licensors' software programs will usually be protected under some form of intellectual property law, namely, patent,⁴⁹

(alleged infringer's insurance forms protected because underlying idea could only be expressed in limited number of ways, which necessarily coincided with plaintiff's form of expression, and to hold otherwise would prevent alleged infringer's expressing the same idea); *Original Appalachian Artworks v. Blue Box Factory*, 577 F. Supp. 625 (S.D.N.Y. 1983) ("Cabbage Patch Doll" look-alikes held protectible due to differences in body structure and skin texture).

Thus the particular way a software licensor expresses his idea in the program cannot be copied by anyone (unless both his rights to the copyright as well as to the physical disk, including the source and object code, were sold). However, a computer program could be written (or copied, then cleverly disguised) by a potential misappropriator with access to a licensor's source code "without risk of infringement, so long as the source code used to implement this function does not infringe the expression of the source code of the pre-existing copyrighted program." Gesmer, *Developments in the Law of Computer Software Copyright Infringement*, 26 JURIMETRICS J. 224, 226 (1986). In an action for software infringement, it would be very difficult for the licensor/creator of the original program to prove that there was infringement unless he could show that the infringer copied verbatim or that the copying of the idea was so extensive or so blatant that it constituted an improper appropriation. See *Arnstein v. Porter*, 154 F.2d 464, 468-69 (2d Cir. 1946), *cert. denied*, 330 U.S. 851 (1947).

⁴⁸ Conley, *supra* note 18, at 582.

⁴⁹ Software licensors usually do not seek patent protection for their programs due to the inherent difficulties involved with obtaining patent protection for computer software. Under 35 U.S.C. § 101 (1982), a patent may be obtained to protect "any new and useful process, machine, manufacture, or composition of matter." Computer software would appear to come under the "process" heading. However, the issue surrounding software patentability is whether software is to be regarded as a mathematical algorithm, which is not subject to patent protection, "an application thereof, which is subject to patent protection or a non-mathematical algorithm," which is also subject to patent protection. BENDER, *COMPUTER LAW, SOFTWARE PROTECTION* § 3A.01 at 3A-2 (1988).

Generally, the test is whether a patent is sought to protect an abstract formula or a formula that is embodied as part of a physical "structure or process which, when considered as a whole, performs a function which the patent laws were designed to protect (e.g. transforming or reducing an article to a different state or thing)." *Id.* at 3A-2.1. Mathematical formulae, though newly discovered, are not patentable as such. Indeed, the Supreme Court has long held that "a scientific truth, or the mathematical expression of it, is not a patentable invention." *Rejection of Computer Software, supra* note 18, at 362 n.4 (citing *Mackey Radio & Tel. Co. v. Radio Corp. of Am.*, 306 U.S. 86, 94 (1939)). See also *Gottschalk v. Benson*, 409 U.S. 63 (1972). However, the 1981 Guidelines on the patentability of software indicate that mere inclusion of a mathematical algorithm in a claim will not render it non-statutory. BENDER § 3A.04 at 3A-47. This requirement will eliminate most software programs from patent protection because most software programs are not part of a structure or a larger process. See *Protections for Software, supra* note 8, at 360.

In addition, there are several other requirements which must be met in order to obtain patent protection. 35 U.S.C. § 102 requires that the program be "novel" or new. 35 U.S.C. § 103 requires that the program be "non-obvious." Both of these requirements will effectively eliminate the majority of computer programs that are submitted for patent protection since most methods of writing a computer program are not novel, and even in instances where the program is found novel, the claim may fail due to the

copyright,⁵⁰ or trade secret law;⁵¹ these laws will not always ensure the

non-obviousness nature of the program. The standard for patentability is thus a strict one. A person must develop something "not previously conceived by anyone alive." BENDER §3A.02 at 3A-6 n.4. Most computer programs will not be able to meet this standard since the process by which a program is designed is generally known by anyone else "having ordinary skill in the art" of designing software programs. 35 U.S.C. § 103 (1982). At best, patent protection could be extended to the "programmable process embodied in the computer program, or the programmed machine[.] . . . [but] . . . it is difficult to see how it could possibly extend to the database or to documentation." BENDER § 3A.07[2] at 3A-69.

One of the disadvantages which discourage software developers from seeking patent protection is the length of time involved in obtaining a patent. By the time the patent is issued, often two to five years after the request is made, the program will probably be preempted by another one. Another problem is the full disclosure that must be made in any application. The application for patent protection "becomes a public record, and anyone may duplicate it without a license with little chance of being caught." *Protections for Software*, *supra* note 8, at 361. Understandably, software developers are reluctant to do this because of the relative ease with which computer programs may be copied. See *supra* notes 46-47 and accompanying text. For a more detailed explanation of the advantages and disadvantages of seeking patent protection for software programs, see BENDER § 3A.07 at 3A-68 - 3A-73.

⁵⁰ See *supra* note 47. U.S. copyright law allows the author of a work to transfer various rights in that work to another person, while retaining other rights for himself. Among those rights are the exclusive rights to reproduce, prepare derivative works, and distribute copies by sale or other transfer of ownership, or by rental or lease. See 17 U.S.C. § 117 (defining transfers), § 106 (enumerating the various exclusive rights in a work) (1982). The provision dealing specifically with the limitation of exclusive rights in computer programs is laid out at 17 U.S.C. § 117 (1982).

A transfer of any of the owner's exclusive rights may be either exclusive or non-exclusive. In the software licensing context, an exclusive transfer gives the licensee "something comparable to title in a separable piece of the original copyright." Hemnes & Montgomery, *The Bankruptcy Code, the Copyright Act and Transactions in Computer Software*, 7 COMPUTER L.J. 327, 347 (1987) [hereinafter Hemnes]. The licensee must register with the Copyright Office, however, in order to maintain the requisite standing to bring suit for any infringements upon his exclusive right. Hemnes points out that if the licensee fails to register in accordance with § 205(c) of the Copyright Act, then the trustee may avoid the license despite the exclusive nature of the transfer under § 544(a)(1) of the Bankruptcy Code. *Id.* at 348 n.76. A non-exclusive license, however, is not a complete transfer of any rights and will almost always be rejectable by a trustee since ownership remains with the licensor. In a case involving a non-exclusive licensee's loss of a right, though actually a privilege, in using the licensed product, "the trustee is [merely] exercising an option the debtor had all along; the option of defaulting." *Id.* at 351. For an excellent analysis of the interaction of copyright recodation on bankruptcy proceedings in software licensing transactions, see generally Hemnes, *supra*.

⁵¹ Before the enactment of the 1976 Copyright Act, trade secret protection under state law was the primary method of protecting computer software programs. Unlike patent or copyright law, the purpose of trade secret protection is to maintain a competitive advantage in the world market. Protection may be maintained without disclosure. Hemnes, *supra* at 371. However, the "element of secrecy is not lost . . . if the holder of the trade secret reveals the trade secret to another in confidence, and under an implied obligation not to use or disclose it." *Kewanee Oil v. Bircon*, 416 U.S. 470, 475 (1974) (quoting *Cincinnati Bell Foundry Co. v. Sodds*, 10 Ohio Dec. Reprint 154, 156 (Super. Ct. 1887)).

After the adoption of the 1976 Copyright Act, however, the issue of preemption of state trade secret law and federal copyright law arose due to the conflicting policies and

degree of protection wary licensors may want. In this light, licensor reluctance is understandable.⁵²

Licensees and licensors have attempted to strike a balance between these interests by requiring the software's source code to be placed in escrow.⁵³ However, escrow arrangements are also not entirely bankruptcy-proof. In an escrow arrangement, the licensor deposits a copy of the source code with the escrow agent—typically a bank, law firm or computer consulting company—for the license's term.⁵⁴ While the source code is escrowed, the licensor must make all modifications and updates to the deposit that are made to the original software. The licensor usually retains title to the deposited source code while the code is in escrow.

Meanwhile, the agent holds the code until the agent receives notice that an event triggering release, such as bankruptcy or the licensor's

purposes of the two types of protection. The courts allowed the use of both forms of protection since trade secret law protects interests that are different from those protected by copyright law. *See* Warrington Assocs. v. Real-Time Eng'g Sys., 522 F. Supp. 367, 369 (N.D. Ill. 1981), cited in Bender, *Protection of Computer Programs: The Copyright/Trade Secret Interface*, 47 U. PITT. L. REV. 907, 927 (1986).

⁵² Additionally, a licensor wishing to protect his software as a trade secret, in order to restrict potential competition with his own product, would have to restrict access to the source code in order to reduce the possibility of having it illegally copied by others. Conley, *supra* note 18, at 582.

The licensor would also have to retain ownership of the program to ensure continued protection under U.S. copyright law. Under the first sale doctrine enunciated in § 109(a) of the Copyright Act, an owner of a copyrighted work's rights is limited after he makes an initial distribution of a copy of that work: "the owner of a particular copy . . . lawfully made . . . is entitled, without the authority of the copyright owner, to sell or otherwise dispose of the possession of that copy . . ." 17 U.S.C. § 109(a) (1982).

⁵³ The software escrow is one of several contractual mechanisms which have been suggested as means by which licensees can reduce their potential losses in the event of licensor bankruptcy. Of these, the escrow arrangement has been the most commonly used and most often discussed. *See, e.g.,* Hemnes, *supra* note 50, at 354-60; Conley, *supra* note 18 at 583; Pappous, *The Software Escrow: The Court Favorite and Bankruptcy Law*, 1 COMPUTER & HIGH TECH L.J. 309 (1985); Nycum, Kenfield & Keenan, *Debugging Software Escrow: Will It Work When You Need It?*, 4 COMPUTER L.J. 441 (1984) [hereinafter Nycum]; Note, *Third-Party Computer Leases: The Effect of the Lessor's Bankruptcy*, 6 COMPUTER L.J. 573 (1986).

⁵⁴ Conley, *supra* note 18, at 583. Conley points out that, in order for escrow arrangements to be most beneficial for the licensee, they must meet four criteria:

First, the proprietor must deposit with the third party source code and supporting documentation sufficient to give the user or its designee a thorough understanding of the software. Second, the proprietor must update the deposit whenever changes are made in the software. Third, a technically competent party must verify the adequacy of the proprietor's deposits. Finally, there must be an immediate turnover of the deposited material to the user or its designee if the proprietor defaults on its obligations for any reason, including bankruptcy.

Id.

failure to update the deposit, has occurred, at which point the agent will turn the code over to the licensee. Upon receipt of the escrowed source code, the licensee's use of it will usually be subject to the conditions laid out in the escrow agreement. These conditions, such as a promise not to disclose the source code to unauthorized persons, will usually be similar to those connected to the object code agreement.⁵⁵ Unfortunately, since the licensor retains title to the escrowed code, it will most likely be retrievable by the trustee as property of the estate in a bankruptcy proceeding.⁵⁶ Additionally, the source code would most likely revert back into the trustee's hands by virtue of its classification as an executory contract due to the licensor's continuing obligation to provide periodic updates.⁵⁷

In a software licensing arrangement of the type contemplated here, the licensee is clearly at a disadvantage. So long as the licensor's business remains financially sound, and both parties continue to meet their contractual obligations, no problems arise for the licensee. If the licensor becomes insolvent, however, the licensee's continued use may be jeopardized regardless of attempts to protect against the effects of rejection.

3. SECTION 365: EXECUTORY CONTRACTS

3.1 Background

Under U.S. bankruptcy law the trustee of the debtor's estate, "subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor."⁵⁸ As early as 1876, the Supreme Court held that "[i]t has long been a recognized principle of the bankrupt [sic] laws that the assignees were not bound to accept property of an onerous or unprofitable character."⁵⁹ Broad powers to assume or reject executory contracts, however, have been granted to trustees through explicit statutory provisions in the Bankruptcy Code since the mid-1930s.⁶⁰ Allowing the rejection of executory contracts relieves

⁵⁵ Hemnes, *supra* note 50, at 355.

⁵⁶ See *infra* notes 82-88 and accompanying text.

⁵⁷ For a detailed discussion of the enforceability of escrows in bankruptcy, see Hemnes, *supra* note 50, at 354-60; Nycum, *supra* note 53, at 460.

⁵⁸ 11 U.S.C. § 365(a) (1982).

⁵⁹ American File Co. v. Garrett, 110 U.S. 285, 295 (1884) (cited in Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 440 (1973) [hereinafter Countryman, *Part I*].

⁶⁰ Countryman, *Part I*, *supra* note 59, at 439. The Bankruptcy Act of 1898 provided that the trustee could reject contracts that were "executory in whole or in part." Bankruptcy Act of 1898, 30 Stat. 544, 566, *repealed by* Bankruptcy Act of 1978, 11 U.S.C. §§ 1-101-151326 (1982 & Supp.).

the debtor from the burden of continued performance and "furthers the fundamental purpose of a reorganization under Chapter 11 of the Bankruptcy Code, which is to avoid a liquidation of the debtor's assets and thereby preserve the jobs and economic resources created by the debtor."⁶¹

Although there is no statutorily established definition of what precisely constitutes an executory contract, Congress adopted Professor Countryman's definition,⁶² whereby "an executory contract is one where . . . something is to be done or not to be done by one or both parties."⁶³ Different circuit courts have made slight variations to this basic definition.⁶⁴ There has generally been agreement, however, as to the definition propriety.⁶⁵ The Bankruptcy Code also does not contain any explicit references regarding whether licensing agreements may be considered executory contracts. Both Professor Countryman and a recent line of cases⁶⁶ confirm that the definition of an executory contract is broad enough to encompass software and other types of technology

⁶¹ Tamietti, *supra* note 31, at 299 (footnote omitted).

⁶² See S. REP. NO. 989, 95th Cong., 2d Sess. 58-60, reprinted in 1978 CODE CONG. & ADMIN. NEWS 5787, 5844 ("Though there is no precise definition of what contracts are executory, it generally includes contracts on which performance remains due to some extent on both sides.") [hereinafter S. REP. NO. 989]. See also Cook, *Judicial Standards for Rejection of Executory Contracts in Bankruptcy Code Reorganization Cases*, 1980 ANN. SURV. L. 689, 691; Hemnes, *supra* note 50, at 344.

⁶³ See Countryman, *Part I*, *supra* note 59, at 460; Countryman, *Executory Contracts in Bankruptcy, Part II*, 58 MINN. L. REV. 479, 480 (1974) [hereinafter Countryman, *Part II*].

⁶⁴ See, e.g., *In re American Magnesium Co.*, 488 F.2d 147 (5th Cir. 1974); *King v. Baer*, 482 F.2d 552 (10th Cir. 1973); *Workman v. Harrison*, 282 F.2d 693 (10th Cir. 1960); *In re Harms*, 7 Bankr. Ct. Dec. (CRR) 671 (Bankr. D. Colo. 1981); *In re Brethren's Home*, 5 Bankr. Ct. Dec. 658 (S.D. Ohio 1979); see also *In re Adolphsen*, 38 Bankr. 776 (Bankr. D. Minn. 1983); *In re Booth*, 19 Bankr. 53 (Bankr. D. Utah 1982); *In re Gladding Corp.*, 22 Bankr. 632 (Bankr. D. Mass. 1982) (Countryman definition not the ultimate test; nature of the parties and the goals of reorganization are determinate).

⁶⁵ See, e.g., *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985) *cert. denied sub nom.* *Lubrizol Enters., Inc. v. Canfield*, 475 U.S. 1057 (1986) ("This court has recently adopted Professor Countryman's more specific test for determining whether a contract is 'executory' in the required sense."); *Gloria Mfg. v. Int'l Ladies' Garment Workers' Union*, 734 F.2d 1020, 1022 (4th Cir. 1984) (court chose to apply Countryman's analysis of executory contracts in favor of "the classic formulation by Williston"); *Benevides v. Alexander*, 670 F.2d 885 (9th Cir. 1982) (a deposit receipt sales agreement was deemed executory under the Countryman definition); *Fenix Cattle Co. v. Silver* (*In re Select-a-Seat Corp.*), 625 F.2d 290 (9th Cir. 1980) (Countryman's definition adopted by the court and applied to a software licensing agreement) *In re Fashion Two Twenty, Inc.*, 16 Bankr. 784, 786 (Bankr. N.D. Ohio 1982) ("The courts have generally accepted and applied the Countryman definition which this Court also adopts").

⁶⁶ For a general discussion of these cases, see *infra* text accompanying notes 90-136.

licensing agreements.⁶⁷

Software licensing arrangements usually involve a continuous relationship between the licensor and licensee, requiring performance obligations from both. As a result, there is a sufficient degree of bilateral involvement for these agreements to be considered executory, and thus consistent with Countryman's definition. Courts have found, for instance, that the "obligation to defend a patent and indemnify the licensee against infringement suits [satisfies] the conditions for an executory contract."⁶⁸ Additionally, the fact "that obligations may be contingent and never realized does not preclude a contract from being executory."⁶⁹ Once a software license is deemed executory by a court, the trustee or debtor-in-possession may choose to reject it if the court determines subsequently that it meets one of several acceptable standards.

The trustee's ability to reject an executory contract stems from the early decisions which permitted the abandonment of executory contracts that were of an onerous and unprofitable nature.⁷⁰ Rejection in those cases was conditioned upon a showing by the trustee or debtor-in-possession that disallowance would "cause an actual economic loss to the estate and drain its corpus, [and] not merely be less profitable than expected."⁷¹ This burdensome test gave a substantial amount of discretion to the courts and thus led to inconsistent results, depending upon each court's definition of "burdensome."⁷² As such, this standard is "presently disfavored and not required under the Bankruptcy Code."⁷³

The majority of courts now apply the business judgment test,⁷⁴ a less stringent standard that broadened the authority of the trustee.⁷⁵ In

⁶⁷ "[T]here may be an implied undertaking by the licensor which brings all patent licenses within the ambit of an executory contract . . . all patentee-licensors are now substantially in the position of having warranted their licensees the validity of their patents. Although the sanction for the breach of such warranty is only forfeiture of royalties rather than liability for damages, this continuing undertaking by the licensor is enough to justify the treatment of all unexpired patent licenses as executory contracts." Countryman, *Part II, supra* note 63, at 502.

⁶⁸ *Rejection of Computer Software, supra* note 18, at 376.

⁶⁹ *Id.*

⁷⁰ See Countryman, *Part I, supra* note 59, at 440.

⁷¹ Cook, *supra* note 62, at 693 (citing Shanker, *The Treatment of Executory Contracts and Leases in the 1978 Bankruptcy Code*, PRAC. LAW, Oct. 15, 1979, at 11, 20). See also *In re Lafayette Radio Elecs. Corp.*, 8 Bankr. 528, 533 (Bankr. E.D.N.Y. 1981).

⁷² See *Rejection of Computer Software, supra* note 18, at 379.

⁷³ *In re Midwest Polychem Ltd.*, 61 Bankr. 559, 562 (Bankr. N.D. Ill. 1986).

⁷⁴ See, e.g., *Lubrizol*, 756 F.2d at 1046-7; *Robertson v. Pierce (In re Chi-Feng Huang)*, 23 Bankr. 798, 801 (9th Cir. 1982); *In re Leibinger-Roberts, Inc.* (Bankr. S.D.N.Y. Oct. 5, 1989)(LEXIS Bkrtcy library, cases file); *In re Food City, Inc.*, 94 Bankr. 91, 93 (Bankr. W.D. Tex. 1988); *In re Huff*, 81 Bankr. 531, 537 (Bankr. D. Minn. 1988).

⁷⁵ The business judgment test may have more equitable effects in practice. For

a determination of whether rejection should be allowed, the trustee need only demonstrate the possibility of benefit to the estate, particularly the general unsecured creditors, if rejection was permitted. The trustee's judgment has usually been upheld absent indicia that the decision was made in bad faith or in gross abuse of business discretion.⁷⁶ Under this standard, "as long as rejection is supportable as a matter of sound business judgment, it will not be denied on the ground that the estate can continue to realize a net financial benefit in the absence of disaffirmance."⁷⁷ The standard is applicable in any situation involving the rejection of a contract that has been characterized as executory, as its purpose is to "emphasiz[e] potential greater profit for the debtor's estate[.]" and as such, the best and most practical approach would be to apply a "flexible test for determining when a contract may be rejected."⁷⁸ Indeed, the business judgment standard has been applied in numerous cases involving the rejection of software licensing arrangements.

3.2 Consequences of Rejection

Upon the rejection of an executory software license, the trustee notifies the licensee that the debtor will not continue its ongoing affirmative obligations under the agreement.⁷⁹ The debtor can also prohibit the licensee from further use of the program as provided in the agreement. While the licensee cannot compel specific performance, he does have a breach of contract claim under section 365(g) and may file a claim for monetary damages as a general unsecured creditor.⁸⁰ If the

instance, where the burdensome standard is applied, requiring a trustee to show that the value of the estate would be significantly decreased, or present affirmative proof that rejection will benefit the estate is overly restrictive. It also adds an element of potential injustice to the debtor's interests. When the proceedings are held, "[i]t may be too early to predict whether . . . [they] . . . will ultimately be successful in rehabilitating the debtor when the trustee is faced with the decision of which executory contract will be assumed and which rejected." *Control Data Corp. v. Zelman* (*In re Minges*, 602 F.2d 38, 43 (2d Cir. 1979)). The burdensome standard also dilutes greatly the scope of the trustee's power to effectively manage the debtor's estate. As a result, it could "cause injustice to the debtor and contravene the very purpose of the bankruptcy laws, which is to benefit the debtor's estate to the fullest extent possible." Nimmer, *Executory Contracts in Bankruptcy: Protecting the Fundamental Terms of the Bargain*, 54 U. COLO. L. REV. 507, 529 (1983).

⁷⁶ H.R. REP. NO. 1012, *supra* note 17, at 5.

⁷⁷ Cook, *supra* note 62, at 696. See also *In re Minges*, 602 F.2d at 42, 43 (2d Cir. 1979).

⁷⁸ *Rejection of Computer Software*, *supra* note 18, at 380 (citing *In re Minges*, 602 F.2d at 43).

⁷⁹ Drabkin, *supra* note 39, at 12-30. See also *In re Select-a-Seat Corp.*, 625 F.2d at 292-93.

⁸⁰ 11 U.S.C. § 365(g) (1982). Section 365(g) provides, in relevant part, "the rejec-

trustee chooses, he can re-license the software program to the licensee at a higher price or resell the software program to a new licensee.

If the licensee has entered into an escrow agreement, his ability to claim the source code upon bankruptcy could be restricted even if the arrangement provided for the licensee's access upon bankruptcy. The trustee could reclaim the source code from the escrow agent under section 542(a),⁸¹ which requires that any entity in possession, custody, or control of property of the estate⁸² must turn it over to the trustee. The property must be returned "wherever located and by whomever held."⁸³ If the escrowed source code constituted property of the estate, "the bankruptcy court's jurisdiction [extends] both to the physical property represented by the medium bearing the code (tape, disk, etc.) and the intellectual property embodied in the code."⁸⁴ Thus, the escrow agent could be compelled to turn over its copy of the source code to the trustee upon demand.⁸⁵

The automatic stay provision, section 362, can also prevent a licensee from taking any action to obtain an escrowed source code.⁸⁶ Under this provision, a filing for protection under the bankruptcy laws acts as an automatic stay of any action against the licensor or any act to obtain possession of or control over any property belonging to the licen-

tion of an executory contract or unexpired lease of the debtor constitutes a breach of such contract or lease." See also *Lubrizol*, 756 F.2d at 1048 ("Under 11 U.S.C. § 365(g), *Lubrizol* would be entitled to treat rejection as a breach and seek a money damages remedy; however, it could not seek to retain its contract rights in the technology by specific performance even if that remedy would ordinarily be available upon breach of this type of contract.").

⁸¹ 11 U.S.C. § 542(a) (1982). This section provides, "[A]n entity other than a custodian, in possession, custody, or control, during the case, of property that the trustee may use, sell, or lease . . . , or that the debtor may exempt . . . shall deliver to the trustee, and account for, such property or the value of such property, unless such property is of inconsequential value or benefit to the estate."

⁸² See *supra* note 81.

⁸³ 11 U.S.C. § 541(a) (1982).

⁸⁴ Conley, *supra* note 18, at 589 n.59.

⁸⁵ While section 542 requires an individual, including the escrow agent, in possession of property of the estate to turn it over to the trustee, there is one exception by which a licensee might obtain the source code and avoid section 542. Under the exclusion in section 542(c), "an entity that has neither actual notice nor actual knowledge of the commencement of the case concerning the debtor may transfer property of the estate . . . in good faith . . . to an entity other than the trustee, with the same effect . . . as if the case . . . concerning the debtor had not been commenced." 11 U.S.C. § 542(c) (1982). Thus, a licensee could "notify the escrow agent that a delivery condition has occurred" without informing the agent that bankruptcy proceedings had been commenced. Nycum, *supra* note 53, at 462. The responsibility of notification would then fall upon the licensor. *Id.*

⁸⁶ 11 U.S.C. § 362 (1982).

sor's estate.⁸⁷ A licensee who violates the automatic stay⁸⁸ could be held in contempt of court.⁸⁹

These provisions added further risk to the licensees' position by closing the channels by which injured parties to a contractual arrangement could customarily seek relief. Such injury is considered justifiable in the bankruptcy context; however, it is a particularly harsh result for technology licensees due to the unique nature of intellectual property.

4. LUBRIZOL AND ITS AFTERMATH: A THREAT TO THE LICENSING MECHANISM?

Although the business judgment standard has eased the burden of trustees seeking to reject executory contracts, it has not permitted rejection in every instance. An examination of the cases addressing the ability to reject technology licenses illustrate that courts have been amenable to a balancing of the interests involved and consideration of the consequences of rejection upon the parties. The courts have not upheld a trustee's business decision to reject as a rule of thumb. The Fourth Circuit's decision in *Lubrizol* produced an unfortunate result. There is no clear indication, however, that the *Lubrizol* result would have become the norm in all software and technology licensing bankruptcies. The following survey of cases will begin with a brief examination of two of the leading cases decided prior to *Lubrizol*. While they do not necessarily involve technology licenses, their rationales are relevant, and

⁸⁷ 11 U.S.C. §§ 362(a)(1)-(2) (1982).

⁸⁸ 11 U.S.C. §§ 362(d)-(f), however, provide a procedure by which a licensee could be excused from the automatic stay after a notice and a hearing. Under sections 362(d)(1) and (2), a court may grant relief for cause, such as "the lack of adequate protection of an interest in property of such party in interest;" or if either the debtor does not have an equity in the property or if the property "is not necessary to an effective reorganization."

Under section 362(e), the stay will be terminated as to the party requesting termination thirty days after a request for relief unless the court "orders such stay continued in effect pending, or as a result of, a final hearing and determination."

Under section 362(f), the court must grant a request for relief from an automatic stay "as is necessary to prevent irreparable damage to the interest of an entity in property, if such interest will suffer such damage before there is an opportunity for notice and a hearing."

⁸⁹ Conley, *supra* note 18, at 592 (citing *In re Holland*, 21 Bankr. 681, 689 (Bankr. N.D. Ind. 1982)). If a party is found in contempt, that party's "lack of knowledge the pendency of the proceeding is *not* a defense." Nycum, *supra* note 53, at 456.

In *In re Holland*, the creditor was held in contempt of court after receiving notice of the debtor's discharge from his obligations under bankruptcy law yet refusing to deliver monies in violation of section 362's automatic stay. The creditor was required to pay the debtor the monies it had retained pursuant to payroll deductions after the petition date, plus any accrued interest. In addition, the creditor was required to pay costs of instituting the suit and attorney's fees. *In re Holland*, 21 Bankr., at 689.

their consideration is warranted for their precedential value in subsequent cases.

4.1 *Pre-Lubrizol*

Several courts in the cases prior to *Lubrizol* generally supported a balancing of the interests in a determination of whether rejection would benefit the general unsecured creditors.⁹⁰ In an early case arising under the Bankruptcy Act, *In re Minges*,⁹¹ the Second Circuit alluded to the propriety of using a balancing test by noting that a bankruptcy court must exercise its discretion fairly “in the interest of all who have had the misfortune of dealing with the debtor.”⁹² The court in *In re Chi-Feng Huang*, a case involving the rejection of an executory contract to sell the debtor’s apartment, further expanded this concept.⁹³ In determining potential benefit to unsecured creditors, the court indicated that “this may involve a balancing of interests.”⁹⁴ It relied on the Second Circuit’s reasoning in *In re Minges* to assert the propriety of disallowing rejection in cases where the damage to the non-rejecting party would be disproportionate to any benefit to be derived by the estate’s general unsecured creditors.⁹⁵ Rejection, however, would not be sanctioned merely “because of a generalized concern that a party whose contract is rejected will be damaged.”⁹⁶

In 1983, the court in *In re Petur* adopted this rationale in disal-

⁹⁰ See, e.g., *Turbowind, Inc. v. Post Street Management, Inc. (In re Turbowind, Inc.)*, 42 Bankr. 579 (Bankr. S.D. Ca. 1984).

⁹¹ 602 F.2d 38 (2d Cir. 1979).

⁹² *Id.* at 43.

⁹³ *In re Chi-Feng Huang*, 23 Bankr. 798 (Bankr. 9th Cir. 1982). The issue there focused upon the debtors’ most valuable asset, an apartment complex which had been sold to appellee. Appellee had paid no part of the purchase price nor taken possession of the complex at the time debtors filed for protection under Chapter 11. While the appellee attempted to seek relief from automatic stay, the trustee of the estate responded by seeking to reject the contract. *Id.* at 799.

⁹⁴ *Id.* at 801.

⁹⁵ *Id.* The trial court in this case disallowed rejection on the ground that it would primarily benefit the two debtors and not the creditors. This conclusion was based on the belief that “each estate [was] solvent and that most of the unsecured claims scheduled in the case [were] ‘questionable’ debts owing to friends or relatives of the debtors or to The Kaleidoscope [a corporation owned and run by the debtors].” *Id.* at 799-800. The court found this reasoning to be erroneous because the reasoning assumed that a) “questionable” claims were invalid, and b) benefits to friends or relatives inured to the debtors. The court reversed and remanded the case to the trial court for further consideration. *Id.*

⁹⁶ *Id.* at 801. Damaged expectations of a licensee also do not constitute sufficient grounds for disallowing rejection: “Any rejection will inevitably entail the disappointment of legitimate expectations. A basic policy of the Bankruptcy laws is to spread the burdens evenly among those who may have loaned the debtor money and those who might have obtained a profit from dealing with him.” *Id.*

lowing the rejection of a licensing agreement despite the fact that the debtor had properly exercised its business judgment in seeking rejection.⁹⁷ The twenty-year licensing agreement entered into between the debtor licensor, Petur U.S.A., and the licensee, Petur of Canada, was of an executory nature, involving continuing obligations from both parties.⁹⁸ While Petur of Canada's business was immensely successful, Petur U.S.A.'s business showed a continuous and significant loss. Petur U.S.A. therefore sought to terminate the licensing agreement, claiming that it was the most significant cause of its financial problems.⁹⁹

According to the court, a bankruptcy court was a court of equity and as such, it could not authorize rejection where its effect would be the "actual ruination of an otherwise profitable, successful and ongoing business."¹⁰⁰ It considered the effects of rejection on both licensor and licensee¹⁰¹ and ultimately concluded that the losses associated with the destruction of Petur of Canada's business far outweighed any benefits to the debtor's estate.

4.2 *Lubrizol*

Lubrizol involved a non-exclusive licensing agreement to use a metal coating process owned by Richmond Metal Finishers (RMF) which was RMF's most valuable asset. Under the agreement the licen-

⁹⁷ *In re* Petur U.S.A. Instrument Co., 35 Bankr. 561 (Bankr. W.D. Wash. 1983).

⁹⁸ Petur U.S.A. and Petur of Canada entered an agreement whereby Petur of Canada was granted the exclusive right to use, manufacture, assemble and sell Petur U.S.A.'s products. In addition, it would provide Petur of Canada with monthly consulting services and the relevant techniques and know-how. Lastly, Petur of Canada received the right to purchase the components from its licensor at a percentage of the production cost as well as the right to use Petur U.S.A.'s trademark. Petur of Canada, in return, paid Petur U.S.A. an up-front fee of \$100,000 for the license and a royalty of three percent of all future gross sales derived from the license. *Id.* at 562.

⁹⁹ The debtor maintained that rejection would allow it to benefit from the proceeds it would receive from the Canadian market. It projected that sales in Canada would yield \$200,000 to \$280,000 in profits annually. *Id.*

¹⁰⁰ *Id.* at 564.

¹⁰¹ The Petur court considered five factors in reaching its conclusion:

First, it is not evident that the debtor will be able to reorganize, even if allowed to reject the contract. Second, more than 120 days have elapsed since this Chapter 11 case was filed, and as yet the debtor has not proposed a plan of reorganization. Third, . . . the profits that the debtor envisions are only projections based on little, if any, experience in the Canadian market. Fourth, there is no evidence of any new capital coming into the debtor. Fifth, the evidence indicates that Petur of Canada has been effective in retailing in the Canadian market and has shown consistent profits over the last four years. There is no evidence indicating a reverse of this trend in the future and it is doubtful if the debtor would be able to do better.

Id. at 564.

sor, RMF, was required to notify and defend Lubrizol in the event an infringement action was brought, to notify Lubrizol of any other use or licensing of the process and to reduce the royalty fee accordingly if another licensee paid a lower rate, and to indemnify Lubrizol for any losses arising from misrepresentation or breaches of warranty by RMF.¹⁰² In return, Lubrizol was required to account for, and to pay royalty fees for, the use of the process. RMF filed for bankruptcy pursuant to Chapter 11, and sought the court's approval to reject the licensing agreement in order to pursue a more profitable arrangement with a new licensee.¹⁰³

The Fourth Circuit allowed rejection, reversing the decision of the district court.¹⁰⁴ The court found the contract executory as to both parties, reasoning that "[t]he un-performed, continuing core obligations of notice and forbearance in licensing made the contract executory as to RMF."¹⁰⁵ The fact that RMF's duty to give notice and to defend in infringement suits was contingent did not preclude the contract from being executory. The court noted, "[U]ntil the time has expired during which an event triggering a contingent duty may occur, the contingent obligation represents a continuing duty to stand ready to perform if the contingency occurs."¹⁰⁶ Also, the continuing obligations connected with the licensee's royalty obligation were sufficient to render the contract executory as to Lubrizol.

The court proceeded to determine whether rejection would be advantageous to the debtor by applying the business judgment test, remaining conscious of the fact that "in corporate litigation the rule is that courts should defer to—should not interfere with—decisions of . . . directors except upon matters entrusted upon a finding of bad faith or gross abuse of their 'business discretion.'" ¹⁰⁷ Upon a consideration of the unrebutted facts presented in the record,¹⁰⁸ it found the

¹⁰² Lubrizol, 756 F.2d at 1045.

¹⁰³ *Id.*

¹⁰⁴ The district court's decision was based on two factors: first, that RMF's obligations under the license were not onerous enough to make relief a substantial benefit to it, and second, because deprivation would strip Lubrizol of all its rights, rejection could not be found beneficial. *Id.*

¹⁰⁵ *Id.* at 1045.

¹⁰⁶ *Id.* at 1046.

¹⁰⁷ *Id.* at 1047. See *infra* notes 120-25 and accompanying text.

¹⁰⁸ The court noted that the evidence as presented to the trial court was not rebutted by Lubrizol. This unrebutted evidence was that:

The metal coating process subject to the licensing agreement is RMF's principal asset and that sale or licensing of the technology represented the primary potential source of funds by which RMF might emerge from bankruptcy. The testimony of RMF's president, also factually uncontested by Lubrizol, indicated that sale or further licensing of the technology

debtor's decision to reject the contract to be based on sound business judgment and, therefore, approved the rejection.¹⁰⁹

The court indicated that Lubrizol could be compensated for the loss of its licensed right by seeking a monetary damages remedy under section 365(g).¹¹⁰ It expressly noted although rejection was to be treated as a breach of contract, the legislative history of section 365(g) indicated that the "purpose of the provision is to provide only a damages remedy for the nonbankrupt party."¹¹¹ Even though it was acknowledged that such allowance of rejection could act as a disincentive upon the willingness of licensees to enter into license agreements with businesses that were financially unstable, the court felt that such a result was justifiable under the bankruptcy laws.¹¹²

4.3 Post-Lubrizol

Despite the Supreme Court's denial of certiorari in *Lubrizol*, many courts continued to follow the directive of *In re Chi-Feng Huang* and *In re Petur*, declining to apply the harsh *Lubrizol* rule.¹¹³ In the 1986 case *In re Logical Software, Inc.*,¹¹⁴ the appellate court reversed the decision of the district court to allow rejection. The licensor, Logical Software, Inc., maintained a business of exclusively developing, licensing and maintaining computer software. Logical Software's two principal products, LOGIX and Softshell software, and its rights to license their use, constituted its principal assets.¹¹⁵ The licensee, Infosystems

would be facilitated by stripping Lubrizol of its rights in the process and that, correspondingly, continued obligation to Lubrizol under the agreement would hinder RMF's capability to sell or license the technology on more advantageous terms to other potential licensees.

756 F.2d at 1047.

¹⁰⁹ RMF's president indicated that "sale or further licensing of the technology would be facilitated by stripping Lubrizol of its rights in the process and that, correspondingly, continued obligation to Lubrizol under the agreement would hinder RMF's capability to sell or license the technology on more advantageous terms to other potential licensees." This fact was uncontested by Lubrizol. *Id.*

¹¹⁰ *Id.* at 1048. See also *supra* note 80.

¹¹¹ 756 F.2d at 1048 (emphasis added). The court concluded that "[a]llowing specific performance would obviously undercut the core purpose of rejection under § 365(a), and that consequence cannot therefore be read into congressional intent." *Id.* But see Nimmer, *supra* note 75, at 529.

¹¹² The court stated: "[U]nder the bankruptcy law such equitable considerations may not be indulged by courts in respect of the contract here in issue. Congress has plainly provided for the rejection of executory contracts, notwithstanding the obvious adverse consequences for contracting parties thereby made inevitable." 756 F.2d at 1048.

¹¹³ See, e.g., Bregnan v. Meehan (*In re Meehan*), 59 Bankr. 380 (Bankr. E.D.N.Y. 1986).

¹¹⁴ 66 Bankr. 683 (Bankr. D. Mass. 1986).

¹¹⁵ *Id.* at 684.

Technology, Inc. (ITI) was the sole possessor of an exclusive license.¹¹⁶ It received a copy of the source code and, under the terms of the agreement, was permitted to “modify that code and market the resulting program under the name LOGIX or another name.”¹¹⁷ ITI modified the source code, developed its own software and subsequently marketed the new product to its customers under the name RUBIX. ITI’s entire operations focused upon RUBIX, providing ITI with 100% of its profits. Due to longstanding disputes between the two parties and endless lawsuits, the licensor filed for bankruptcy pursuant to Chapter 11 and sought to reject the license.¹¹⁸

The court asserted that the bankruptcy court had “adopted an erroneous legal standard when it applied the *Lubrizol* test to the question.”¹¹⁹ It therefore remanded the case, directing the bankruptcy court to apply the balancing test adopted by the courts in cases such as *In re Chi-Feng Huang* and *In re Petur*, and to disallow rejection if ITI would be damaged disproportionate to any benefit the general unsecured creditors would derive. “[T]he Bankruptcy Court,” it instructed, “may want to consider the probable size of ITI’s damage claim against Logical if rejection is allowed, Logical’s likelihood of reorganizing, and the extent of damage to ITI’s business caused by rejection.”¹²⁰

A similar result was also reached in *In re Midwest Polychem, Ltd.*,¹²¹ where the bankruptcy court declined to authorize the rejection of a license after balancing the equities involved: “This court believes that it is appropriate to always consider the equities of the situation and measure the relative effects of rejection before granting approval.”¹²²

Although a number of recent cases have permitted rejection, those courts generally acknowledged that a balancing of the equities was an element that should come into play when applying the business judg-

¹¹⁶ *Id.*

¹¹⁷ *Id.* at 685.

¹¹⁸ *Id.* In seeking rejection, ITI argued that the injury resulting to its business would far outweigh any advantages which might be produced by allowing rejection. ITI indicated that the potential loss to its business would fall somewhere between \$14.4 million and \$62.5 million, as opposed to the periodic royalty fee of \$10,000 which Logical Software would forfeit. *Id.* ITI also claimed that the burdens which would be inflicted upon Logical Software were too insignificant to satisfy the burdensome test. *Id.* at 686.

¹¹⁹ *Infosystems Tech., Inc. v. Logical Software, Inc.*, No. 87-0042 at 3 (D. Mass. June 25, 1987)(WESTLAW, Fed. library, Bankr. file).

¹²⁰ *Id.*

¹²¹ *In re Midwest Polychem*, 61 Bankr. 559 (Bankr. N.D. Ill. 1986).

¹²² *Id.* at 562.

ment test. The court in *In re Southern California Sound Systems*¹²³ permitted rejection but stated that an important factor to be considered was "the size of the claim flowing from the breach caused by rejection."¹²⁴ It determined that the size of the claim in that case would be minimal: the licensor, Southern California Sound Systems (SCSS), was not a business with employees, was not producing anything at the time of the suit, had not yet made any sales, and thus had no accounts receivable.¹²⁵ It also had no assets to undertake a reorganization plan. Lastly, since SCSS had only formed several months before it filed under Chapter 11, the court concluded that "the relatively small unsecured debt cannot be seriously delinquent, if indeed, any delinquency exist[ed] at all."¹²⁶

It should be noted, however, that rejection was based primarily upon a factor unique to the case: evidence in the record indicating that SCSS's filing was clearly executed in bad faith.¹²⁷ Thus, regardless of

¹²³ *In re Southern California Sound Systems, Inc.*, 69 Bankr. 893 (Bankr. S.D. Cal. 1987).

¹²⁴ *Id.* at 896.

¹²⁵ *Id.* at 897.

¹²⁶ *Id.* The record indicated that SCSS's schedules reflected unsecured debts of \$107,770,000, consisting mostly of insider and unsecured loans. However, if the 15-year licensing agreement was fully performed, the potential value of the contract was calculated to be \$78,570,000, as gross sales were estimated to be about \$5,328,000 annually. In addition, the licensor's schedules reflected assets of \$67,456. Thus, "excluding insider loans, debtor's schedules indicate that more than sufficient assets exist to pay all unsecured creditors in full." *Id.* at 896.

¹²⁷ *Id.* at 898. In this case, SCSS had entered into a licensing arrangement with the licensee, Starburst Marketing International, Inc. (SMI), in order to broaden public exposure to its new loudspeakers. SMI was granted an exclusive license to sell loudspeakers produced by SCSS in an arrangement similar to that in *Logical Software*. *Id.* Under the terms of the agreement, SMI was required to purchase 80% of all loudspeakers produced by SCSS, and was then permitted to sell all loudspeaker units and exclusive rights to any trademarks worldwide. Additionally, SCSS agreed to grant SMI a license of the patent to SMI in the event SCSS was unwilling or was unable to produce enough loudspeakers to fill SMI's needs. In return, SMI was to pay SCSS a royalty of 6% on every loudspeaker unit sold. Disputes between the parties ensued immediately after the licensing arrangement was concluded and, upon failing to obtain investors to finance the production of loudspeakers, SCSS sought to cancel the licensing agreement. SMI brought an action against SCSS for breach of contract seeking \$6 million in damages. SCSS retaliated by filing under Chapter 11. *Id.* at 895.

The record included a statement by the president of SCSS indicating that the case was filed for the sole purpose of rejecting a burdensome contract. The declaration of Ronald Vale, president of SCSS, stated:

The debtor filed this case for the purpose of rejecting a burdensome contract; to gain the protection offered by the automatic stay provisions under the Code; to buy time after the rejection, to solicit funding for its projects and to thereafter propose and complete a successful plan of reorganization. Without the continued protection of this court, the debtor will expire and the time efforts, monies and energies expended by the principals of SCSS over these past years will all have been for naught.

the inequities involved with permitting or disallowing rejection, the court declared where "the true purpose of filing a petition [was] other than to reorganize a financially distressed business," and "to merely take advantage of one of the remedies available under the Code, dismissal is appropriate in order to protect the jurisdictional integrity of the Court."¹²⁸

The court did express approval of the *In re Logical Software* rationale, but it distinguished that case from *SCSS*.¹²⁹ Unlike *SCSS*, Logical Software had been operating a business for five years before filing for bankruptcy. It was "a real company with real debt and real creditors to enforce it."¹³⁰ Although the relationships between the parties in the two cases were similarly marked by discord, Logical Software had made attempts to resolve its disputes with ITI before it sought to reject the contract.¹³¹ Lastly, Logical Software's decision to reject, unlike *SCSS*'s, indicated nothing more than "the exercise of its sound business judgment as but one step towards successful reorganization."¹³²

Some courts expressed uncertainty regarding the appropriateness of a bankruptcy court's indulging in equitable considerations where the rejection of a technology license was concerned, but nevertheless engaged in a balancing of sorts. The discussions in *In re Chipwich, Inc.*¹³³ and *In re Laser Disc Computer Systems, Inc.*,¹³⁴ did not expressly sanction the balancing approach, yet alluded that rejection might have been disallowed had there been some factual indicia that rejection would have resulted in damage to the licensees that would be disproportionate to the possible benefits to the general unsecured creditors. Both courts referred to and distinguished *In re Petur*. The bankruptcy judge in *Laser Disc*, for instance, distinguished the case by noting that "the Petur Instrument Court expressly based its decision on five factors, none of which exist here."¹³⁵ Likewise, in *Chipwich*, there was no showing that the licensee would be damaged disproportionately as in *Petur*.¹³⁶

This brief survey indicates that the threat from *Lubrizol* was certainly not a clear one; in fact, doubt has been raised as to the correct-

Id. at 898.

¹²⁸ *Id.* at 900.

¹²⁹ *Id.* at 899.

¹³⁰ *Id.*

¹³¹ *Id.*

¹³² *Id.*

¹³³ 54 Bankr. 427 (Bankr. S.D.N.Y. 1985).

¹³⁴ No. 85-00535, slip. op. (D. Mass. Oct. 8, 1985) (LEXIS, Genfed library, Bankr. file).

¹³⁵ *Id.* at 3. See also *In re Chipwich, Inc.*, 54 Bankr. at 431.

¹³⁶ 54 Bankr. at 431.

ness of the decision itself.¹³⁷ Given time, the balancing test would have most likely settled the problems that persisted in cases involving the rejection of software and other technology licensing agreements.¹³⁸ Nonetheless, the fears of the computer industry were able to convince Congress that the need for relief to this dilemma was immediate.¹³⁹

5. THE SOLUTION: THE INTELLECTUAL PROPERTY BANKRUPTCY PROTECTION ACT

5.1 *The Congressional Response*

On August 7, 1987, Senators DeConcini (D-Ariz.) and Heflin (D-Ala.) introduced S. 1626,¹⁴⁰ the Intellectual Property Bankruptcy Protection Act of 1987, in response to concerns from the computer industry regarding the potentially detrimental effects of the *Lubrizol* decision. It was feared that the wide discretion courts allowed licensors and their trustees to reject a technology licensing agreement in the event of bankruptcy would "effectively sound a death knoll [sic] for the small business dependent on intellectual property for the success of its operation."¹⁴¹ Uncertainty surrounding the present state of the law, noted DeConcini, "jeopardizes American technology licenses in the world market."¹⁴²

In his introductory remarks to S. 1626, Senator DeConcini stated that at the time the present Bankruptcy Code¹⁴³ was considered for

¹³⁷ See H.R. 4657, *supra* note 26, at 67, 71 (testimony and statement of George A. Hahn).

¹³⁸ George Hahn, on behalf of the National Bankruptcy Conference, indicated that the balancing test was, in fact, "the preferable test and . . . more reasonable test." *Id.* at 103 (testimony by George A. Hahn). He noted: "I think ultimately the courts will adopt [it]. I think there is a general tendency slowly gathering momentum in that general direction, which will take several years. I believe that if it can be worked out by the courts, it's better being left with the courts rather than to be legislated." *Id.* at 100.

¹³⁹ See, e.g., *id.* at 93, 96, 99.

¹⁴⁰ S. 1626, 100th Cong., 1st Sess., 133 CONG. REC. 11,653-55 (1987) (Intellectual Property Bankruptcy Protection Act).

¹⁴¹ *Id.* at 11,654. See also *Senate Bill Would Protect Technology Licensees If Licensor Goes Bankrupt*, 34 Pat. Trademark & Copyright J. (BNA) 378 (August 13, 1987).

¹⁴² S. 1626, *supra* note 140, at 11,654.

¹⁴³ U.S. bankruptcy law was first designed and effectuated in 1898 and was revised in 1938. However, changes in the nature of debtor-creditor law, the adoption of the Uniform Commercial Code in the 1960s, and an increasing number of bankruptcies eventually made revisions to the 1938 Bankruptcy Code a necessary step towards modernization. S. REP. NO. 989, *supra* note 62, at 2-3. In 1970, a commission was created by Congress "to study and recommend changes in bankruptcy laws." *Id.* at 1. A two-part report was completed in 1973, consisting of the commission's findings and recommendations and a draft bill implementing those recommendations. *Id.* at 1-2.

After extensive hearings and numerous redraftings throughout 1975 and all of

revisions in the early 1970s, Congress did not address this issue "because no courts had considered it before the Bankruptcy Reform Act of 1978 and because it requires the application in bankruptcy cases of the very specialized area of intellectual property law."¹⁴⁴ It was concluded that this "quirk" in the bankruptcy law must therefore be remedied in order to preserve U.S. competitiveness in the world technology market.¹⁴⁵

S. 1626 proposed an amendment to section 365 which would allow software and other technology licensees to retain use of licensed intellectual property after the licensor files for bankruptcy and rejects the contract.¹⁴⁶ A trustee who rejected the contract would be relieved of his performance obligations under the contract, but be prohibited from taking any action to deprive or interfere with the licensee's use of the licensed material. S. 1626 included two exceptions to this general provision: a) where the licensing involved trademarks, the licensee was required to comply with the licensor's ongoing quality assurance program;¹⁴⁷ and b) where the licensee is the bankrupt party and the contract required the licensee to maintain the confidentiality of trade secrets, rejection would not relieve the debtor licensee of its obligation to maintain confidentiality.¹⁴⁸ Similar legislation, known as the Intel-

1976 by the Subcommittee on Improvements in Judicial Machinery, the House version of the bill (H.R. 8200) was passed on February 1, 1978. *Id.* at 2. The Senate version, S. 2266, was introduced by Senators DeConcini and Wallop on November 1, 1978. The bill was passed after a series of hearings and revisions that took place over a five month period. *Id.*

¹⁴⁴ S. 1626, *supra* note 140, at 11,654.

¹⁴⁵ *Id.*

¹⁴⁶ S. 1626, *supra* note 140, at 11,654-55 (§ 365(n)(1)-(3)).

¹⁴⁷ *Id.* § 365(n)(2) provides, in relevant part:

[T]he trustee may not interfere with the grantee's rights . . . (C) in the case of a trademark, trade name, service mark, or similar intellectual property, to permit existing grantees to continue in concert the quality assurance procedures of the licensor. If the trustee rejects such a contract or lease, the trustee is relieved only from the specific performance of prospective obligations thereunder measured from the filing date and is prohibited from taking any action which would interfere with the grantee's rights

¹⁴⁸ *Id.* § 365(n)(3) provides:

(3) If the debtor was the grantee under an executory contract or unexpired lease which granted rights in intellectual property, prior to assumption or rejection and notwithstanding rejection of such contract or lease, the trustee, the debtor, and the grantor must maintain the confidentiality of any protected information obtained pursuant to the executory contract or unexpired lease to the extent required by applicable nonbankruptcy law. Prior to assumption or rejection, the grantor is entitled to adequate assurance of the continued confidential treatment of such protected information. If the contract or lease is rejected, upon request by the grantor including an offer of reimbursement of expenses, all materials embodying protected

lectual Property and Bankruptcy Bill (H.R. 4657), was also introduced in the House by Representative Don Edwards (D.-Cal.) on May 23, 1988. H.R. 4657 was based on a draft bill submitted by George A. Hahn on behalf of the National Bankruptcy Conference which was supported by other groups, including the American Bankruptcy Institute and the American Bar Association's Business Bankruptcy Committee.¹⁴⁹ Instead of adding a new section to section 365, the draft bill expanded the existing provisions of section 365(h), allowing the technology licensee to elect to retain the intellectual property, and specifically lists the forms of intellectual property to be protected.¹⁵⁰

H.R. 4657 was modeled after section 365(h)(1),¹⁵¹ which pertains to the rejection of an unexpired lease of real property.¹⁵² Unlike section 365(h)(1), however, the bill did not allow the licensee any right of set-off.¹⁵³ And, unlike S. 1626, H.R. 4657 did not include the exemptions pertaining to trademark licensees or licensees under disclosure agree-

information shall be returned to the grantor. The trustee, after he has received actual notice of the existence of the protected information in the bankruptcy estate, and the debtor, are not, by reason of the rejection, permitted to disclose protected information without the consent of the person to whom the obligation of confidentiality is owed.

¹⁴⁹ In the fall of 1987, after S. 1626 was proposed, the Bankruptcy Licensor Coalition was formed. The Coalition consisted of representatives from U.S. industries. The Coalition approached the National Bankruptcy Conference for its support and assistance with regard to S. 1626. During the winter of 1987 representatives of the Conference and the Business Bankruptcy Committee of the American Bar Association held a series of meetings to discuss the ramifications of S. 1626. The Conference chose to assist with the bill for three reasons: 1) it recognized the potentially harmful effects of the *Lubrizol* decision; 2) it was skeptical about the propriety of the Fourth Circuit's ruling in *Lubrizol* (in particular, its interpretation of the consequences of rejection); and 3) it felt a responsibility to see that any amendments to section 365 would be based on sound bankruptcy principles.

The representatives found that the provisions of S. 1626 were ambiguous and that it "did not reach a satisfactory balance between the needs of debtor licensors of intellectual property on the one hand and the concerns of licensees on the other." H.R. 4657, *supra* note 26, at 71 (statement of George A. Hahn). From the meetings and discussions that were held that winter, the Draft Bill, which is the precursor to H.R. 4657, resulted. *Id.* at 72.

¹⁵⁰ *Hearing on S. 1626 Before the Subcomm. on Courts and Administrative Practice of the Comm. on the Judiciary*, 100th Cong., 2d Sess. (1988) (statement of George A. Hahn, Esq., Hahn & Hessen on behalf of the National Bankruptcy Conference) [hereinafter *Hearings on S. 1626*]; *Technology Licensing and Bankruptcy Are Considered by Senate Subcommittee*, 36 Pat. Trademark & Copyright J. (BNA) 172, 190-91 (June 16, 1988) [hereinafter *Technology Licensing and Bankruptcy Considered*].

¹⁵¹ 11 U.S.C. § 365(h)(1) (1982).

¹⁵² *Technology Licensing and Bankruptcy is Considered by House Subcommittee*, 36 Pat. Trademark & Copyright J. (BNA) 141, 143 (June 9, 1988).

¹⁵³ Under section 365(h)(i), the lessee-in-possession may reduce the amount of rent paid by the amount of damages incurred by lessor's non-performance of the lease.

ments.¹⁶⁴ The House Subcommittee on Monopolies and Commercial Law heard testimony on H.R. 4657 on June 2, 1988. While the panel members agreed that legislation was necessary to remedy this problem,¹⁶⁵ there was concern expressed over certain ambiguities in the proposal, as well as over the possibility that it favored the licensee too heavily.¹⁶⁶

Testimony on DeConcini's bill, S. 1626, was heard on June 10, 1988, at a hearing of the Senate Subcommittee on Courts and Administrative Practice. Like those present at the hearings on H.R. 4657, the participants in the Senate hearings acknowledged the need for legislation in this area and that the DeConcini bill was a good starting point.

¹⁶⁴ *Id.*

¹⁶⁵ Four witnesses testified at the hearing: James Burger, Esq., of Apple Computer, Inc., testifying on behalf of the Computer and Business Equipment Manufacturers Association and the Bankrupt Licensors Coalition; Harry F. Manbeck, Esq., of General Electric Company, testifying on behalf of Intellectual Property Owners, Inc.; George A. Hahn, Esq., of Hahn & Hessen, testifying on behalf of the National Bankruptcy Conference; and Thomas M.S. Hemnes, Esq., of Foley, Hoag & Eliot. *H.R. 4657*, *supra* note 26, at 13.

¹⁶⁶ Mr. Thomas M.S. Hemnes, Esq. opposed the bill, arguing that "[i]t would create substantial inequities by abrogating the fundamental contract principle of mutuality of obligation. It would interfere with the reorganization of debtors by making it practically impossible for a trustee to reject a wide variety of executory contracts that Lubrizol has not affected. It would, finally, jeopardize trade secret protection presently available for intellectual property." *Id.* at 29 (testimony of Thomas M.S. Hemnes, Esq.).

In place of the proposed bill, Mr. Hemnes presented several alternatives to the Committee. First, he suggested that no amendment be added at all in order to give bankruptcy courts more time to devise a method of accommodating technology licenses. Second, he suggested modeling an amendment on 11 U.S.C. § 1113, which protects collective bargaining agreements. An amendment based on section 1113 would require a court to balance the interests of the licensor with the licensee before allowing rejection. It would also permit the licensee to continue the technology until an adequate replacement could be found. Third, Hemnes suggested giving licensees an option of retaining nonexclusive rights which are tied to its obligation to pay and protect the technology. *Id.*

A suggestion was also offered by Mr. Manbeck, concerning the definition of intellectual property in section 1(a) of the bill. As proposed, he felt that the definition in H.R. 4657 could be clarified or made more explicit as to what intellectual property was covered. He suggested that specific reference be made to each form of intellectual property in order to avoid any possible confusion as to what rights were covered. *Id.* at 88 (statement of Harry F. Manbeck, Esq.). As proposed in H.R. 4657, § 1(a) provided:

(52) 'intellectual property' means—

(A) trade secret;

(B) invention, process, design, or plant variety;

(C) work of authorship; or

(D) mask work subject to protection under chapter 9 of title 17; to the extent protected by applicable nonbankruptcy law; and

(53) 'mask work' has the meaning given it in section 901(a)(2) of title 17.

Several objections, however, were raised to S. 1626.¹⁵⁷ The National Bankruptcy Conference's draft bill was also presented as an alternative to S. 1626 and was favorably received by the industry leaders present.¹⁵⁸

Although the draft bill found enthusiastic support, the Senate Subcommittee on Courts and Administrative Practice chose instead to adopt a substitute version of S. 1626 at the August 9, 1988 markup session.¹⁵⁹ The markup version incorporated the suggestions offered at the previous hearings and was essentially identical to the draft bill, the primary difference being that the substitute added a new section to section 365 which dealt with intellectual property licensees in a separate provision.¹⁶⁰ The Subcommittee unanimously approved the substitute amendment and, on the next day, it was unanimously approved by the full Committee on the Judiciary. On September 22, a markup session of its House counterpart, H.R. 4657, was held by the Subcommittee on Monopolies and Commercial Law. The Subcommittee adopted a substitute H.R. 4657 which was essentially the same, but included some technical clarifications.¹⁶¹ Representative Don Edwards introduced this

¹⁵⁷ *Technology Licensing and Bankruptcy Are Considered by Senate Subcommittee*, *supra* note 150, at 172-73. George A. Hahn, testifying on behalf of the National Bankruptcy Conference, laid out its primary objections to S. 1626 as proposed. The objections of the National Bankruptcy Conference were:

a) The definition of intellectual property was too imprecise. Concern was expressed that the inclusion of trademarks, trade names and service marks in the definition would "bring every retail franchise involving a trademark within the purview of the legislation, thus extending the reach of the bill far beyond what appears necessary";

b) The bill did not adequately address the problems concerned with continuing quality assurance for trademarks in the bankruptcy context;

c) The provisions which assured continued confidentiality were already addressed by 11 U.S.C. § 107(b);

d) The provision requiring debtor licensees to maintain confidentiality to the extent required by applicable nonbankruptcy law could be mistakenly interpreted as "prohibiting the debtor from revealing information to his trustee in bankruptcy, thereby interfering with the trustee's ability to operate the debtor's business; and

e) The bill did not adequately assure that the debtor would continue to receive royalty payments.

Hearing on S. 1626, *supra* note 150 (statement of George A. Hahn, on behalf of the National Bankruptcy Conference).

¹⁵⁸ *Technology Licensing and Bankruptcy Considered*, *supra* note 150, at 173.

¹⁵⁹ *Senate Judiciary Committee Approves Bill on Technology Licensing and Bankruptcy*, 36 Pat. Trademark & Copyright J. (BNA) 404 (Aug. 18, 1988).

¹⁶⁰ *Id.*

¹⁶¹ The clarifications made by the Subcommittee were: 1) the definition of intellectual property was clarified to include intellectual property protected under federal patent and copyright laws; 2) the amendment stated on its face that a licensor is bound by contractual provisions that give a licensee exclusive rights; and 3) the amendment

new amendment in the form of a clean bill, H.R. 5348, which was approved on September 27, 1988, by the Committee on the Judiciary. S. 1626 was passed by a unanimous Senate on September 20, 1988, after technical additions were made. S. 1626, along with its House counterpart, H.R. 5348, was passed by the House on October 4, 1988.¹⁶² S. 1626 was signed into law on October 18, 1988.¹⁶³

5.2 The Provisions

The Intellectual Property Bankruptcy Protection Act amends section 365 of the Bankruptcy Code by adding a new section, section 365(n), which consists of four subsections.¹⁶⁴ The amendment deals only with the situation where the licensor is the bankrupt party and rejects or terminates his software or other technology licensing agreement with the licensee. The first subsection gives the licensee an option to either treat the rejection as a breach of contract or to retain his rights to use the contract as stipulated under the licensing agreement.¹⁶⁵ If the licensee chooses the first option, the licensee may treat the contract as terminated and seek redress under section 365(g) of the Bankruptcy

1012, *supra* note 17, at 1-2.

¹⁶² See *House Passes Legislation on Technology Licensing and Bankruptcy*, 36 Pat. Trademark & Copyright J. (BNA) 631 (Oct. 13, 1988); *Senate Passes Legislation on Bankruptcy and Licensing*, 36 Pat. Trademark & Copyright J. (BNA) 549 (Sept. 22, 1988). See also, Miller, *Computer Firms Win Bid to Plug Legal Loophole*, Wall St. J., Oct. 6, 1988, at B5.

¹⁶³ See *President Signs Legislation on Technology Licensing and Bankruptcy*, 36 Pat. Trademark & Copyright J. (BNA) 741 (Oct. 27, 1988).

¹⁶⁴ Intellectual Property Bankruptcy Protection Act, Pub. L. No. 100-506, 102 Stat. 2538 (1988) (to be codified at 11 U.S.C. § 365).

¹⁶⁵ *Id.* Amended section 365(n)(1) provides:

(n)(1) If the trustee rejects an executory contract under which the debtor is a licensor of a right to intellectual property, the licensee under such contract may elect —

(A) to treat such contract as terminated by such rejection if such rejection by the trustee amounts to such a breach as would entitle the licensee to treat such contract as terminated by virtue of its own terms, applicable non-bankruptcy law, or an agreement made by the licensee with another entity; or

(B) to retain its rights (including a right to to [sic] enforce any exclusivity provision of such contract, but excluding any other right under applicable non-bankruptcy law to specific performance of such contract) under such contract and under any agreement supplementary to such contract, to such intellectual property to the extent protected by applicable nonbankruptcy law, as such rights existed immediately before the case commenced, for —

(i) the duration of such contract; and

(ii) any period for which such contract may be extended by the licensee, as of right, under applicable nonbankruptcy law.

Code¹⁶⁶ as an unsecured creditor.¹⁶⁷ If the licensee chooses to retain his rights to the intellectual property,¹⁶⁸ he may retain his rights as well as any embodiment thereof under the licensing agreement and any agreement supplementary to it.¹⁶⁹ The licensee may also enforce any exclusivity provision where applicable¹⁷⁰ for the remainder of the contract's term¹⁷¹ and any period for which it may be extended as of right. However, the licensee cannot compel specific performance.¹⁷²

¹⁶⁶ See *supra* note 80.

¹⁶⁷ Pub. L. No. 100-506, § 1(b) (to be codified at 11 U.S.C. § 365(n)(1)(A)).

¹⁶⁸ The new defined term "intellectual property" under section 365(n) includes:

- (A) trade secret;
- (B) invention, process, design, or plant protected under title 35;
- (C) patent application;
- (D) plant variety;
- (E) work of authorship protected under title 17; or
- (F) mask work protected under chapter 9 of title 17; to the extent protected by applicable nonbankruptcy law

Id. § 1(a). This definition of intellectual property is designed to broadly encompass all forms of intellectual property which are already protected by applicable non-bankruptcy law. S. REP. NO. 505, *supra* note 21, at 7. One unique aspect of this definition is its inclusion of trade secrets, which is usually addressed by state law. However, this is considered appropriate given its application in the bankruptcy context: "[B]ecause bankruptcy processes can alter rights created by state law, this inclusion is appropriate." *Id.*

¹⁶⁹ This contemplates the situation where, for instance, the licensor has deposited a copy of a licensed program's source code to an escrow agent. Where the licensor and licensee have entered into an escrow agreement, stipulating that the source code would be handed over to the licensee upon the occurrence of a triggering event, the licensee would retain his rights in both the licensed object code as well as the source code. The source code constitutes the "embodiment" of the licensed intellectual property, and the escrow agreement which laid out the licensee's rights thereto constitute the "agreement supplementary" to the contract. See S. REP. NO. 505, *supra* note 21, at 9-10.

¹⁷⁰ See Pub. L. No. 100-506, § 1(b) (to be codified at 11 U.S.C. §§ 365(n)(1)(B), (n)(2)(A)).

¹⁷¹ Rights which the licensee may retain are those which existed at the time the licensor filed for bankruptcy. See S. REP. NO. 505, *supra* note 21 at 8. The Senate Report to S. 1626 indicates that the licensee is "entitled to use the underlying intellectual property in the state that it existed on the day of the bankruptcy filing as provided in the license and . . . is entitled to any judicial relief necessary to enforce that set of rights." *Id.* at 9.

¹⁷² This provision is intended to relieve the licensor of any performance obligations, such as maintaining or updating computer software, that may be impractical for the trustee. See *id.* In addition, this provision is intended to minimize the burdens on the debtor licensor: "Future affirmative actions . . . could deplete the bankrupt estate at the expense of the general creditors—while trying to reorganize or make a fresh start." H.R. REP. NO. 1012, *supra* note 17, at 8. However, it does not relieve the debtor of "performing" covenants which do not require action by the trustee, such as permitting the licensee to continue using the software if the licensee chooses to retain. *Id.* at 8-9.

The exclusivity provision is the one exception where the licensee may compel specific performance from the licensor. Where the license granted the licensee an exclusive right to use the technology, then the licensee, under § 365(n)(1)(B), may enjoin the licensor from licensing the rights which are granted to the licensee. *Id.* at 8. See also S. REP. NO.

The second and third subsections present modifications upon the licensee's rights should it elect to retain the licensed material. The second subsection instructs the trustee to allow the licensee to continue exercising his rights to the technology where the licensee has chosen to do so.¹⁷³ In return, the licensee must continue to make royalty payments to the licensor for the duration of the contract.¹⁷⁴ However, the licensee waives any rights of setoff he might otherwise have, as well as any allowable claim for administrative expenses against the estate under section 503(b) of the Bankruptcy Code.¹⁷⁵ This is intended to aid the licensor in his efforts to reorganize. Allowing offset or administrative expenses could defeat the right to royalty payments.¹⁷⁶

The third subsection compels the trustee, upon the written request of the licensee, to provide the technology and any embodiment of the technology to the licensee as provided for in the licensing agreement or a supplementary agreement.¹⁷⁷ The trustee is directed to not interfere with the licensee's rights to use the technology or with efforts by the licensee to obtain the technology or its embodiment from another party.¹⁷⁸ This effectively precludes the trustee from attempting to pre-

505, *supra* note 21, at 9.

¹⁷³ Pub. L. No. 100-506, § 1(b) (to be codified at 11 U.S.C. § 365(a)(2)(A)).

¹⁷⁴ *Id.* As codified, section 365(n)(2)(B) provides: "(B) the licensee shall make all royalty payments due under such contract for the duration of such contract and for any period described in paragraph (1)(B) of this subsection for which the licensee extends such contract." The House Report notes that in determining what payments are to be deemed royalties, courts should "look to the substance of the transaction and not the label. The underlying nature of the payments must be considered." H.R. REP. NO. 1012, *supra* note 17, at 9. For example, if payments which are based on a percentage of the profits derived from the use of the licensed material are provided for in the licensing agreement, then the payments should be treated as royalties regardless of the label affixed thereto. *See id.*

¹⁷⁵ *Id.* As codified, section 365(n)(2)(C) provides: "(C) the licensee shall be deemed to waive—(i) any right of setoff it may have with respect to such contract under this title or applicable nonbankruptcy law; and (ii) any claim allowable under section 503(b) of this title arising from the performance of such contract."

¹⁷⁶ S. REP. NO. 505, *supra* note 21, at 10. The licensee that chooses to retain its rights to the technology still has a general claim for damages arising from the rejection under section 365(g). As the House Report notes, though, any claim for damages is likely to be relatively small where the licensee chooses to retain, as compared with a choice to treat the rejection as a breach of contract under section 365(n)(1)(A). H.R. REP. NO. 1012, *supra* note 17, at 8-9.

¹⁷⁷ Pub. L. No. 100-506, § 1(b). As codified, section 365(n)(3)(A) provides:

(3) If the licensee elects to retain its rights, as described in paragraph (1)(b) of this subsection, then on the written request of the licensee the trustee shall—

(A) to the extent provided in such contract, or any agreement supplementary to such contract, provide to the licensee any intellectual property (including such embodiment) held by the trustee.

Published by Penn State Legal Scholarship Repository (PSLR) provides: "[T]he trustee shall . . . (B) not interfere with the rights of the licensee as provided in such contract, or any agreement

vent the licensee from obtaining, for instance, the escrowed source code of a licensed software program from an escrow agent.

The last subsection describes the duties of a trustee in the period prior to the license's rejection. Unless and until the trustee rejects, he must either continue to perform the contract or provide the licensee with the licensed technology.¹⁷⁹ Furthermore, the trustee must not interfere with the licensee's rights to the technology or to obtain the technology or any embodiment thereof from another party during this period.¹⁸⁰

6. ANALYSIS OF THE INTELLECTUAL PROPERTY BANKRUPTCY PROTECTION ACT

Theoretically, section 365(n) should preserve the United States' competitive position in the world technology market by eliminating a major element of uncertainty for licensees engaging in software licensing transactions. By striking a balance between the interests of licensors and licensees, it is intended to allow foreign licensees to feel more secure with the knowledge that their interests would be protected in the event of licensor bankruptcy when they engage in software licensing agreements with U.S. licensors. Also, as licensing transactions become more reciprocal in nature, section 365(n) will ease the fears of U.S. companies that will be licensing from foreign licensors in the United States. Section 365 renders licensing a practical no-risk situation for a licensee since the licensee no longer needs to be overly concerned with the possibility of losing his business or licensed rights if the licensor become insolvent. However, by focusing too heavily on the plight of the licensee, the drafters of section 365(n) failed to strike the aforementioned balance between licensor and licensee in several respects.

6.1 General Effects

A primary flaw in the amendment is the failure of the drafters to fully consider its potential effects upon the rights of an insolvent licensor. Not every rejection will result in irreparable damage to the licensee. By taking the reins out of the licensor's hands and putting them into the hands of the licensee, section 365(n) assumes in all cases that rejection of a technology licensing agreement will irreparably harm the

supplementary to such contract, to such intellectual property (including such embodiment) including any right to obtain such intellectual property (or such embodiment) from another entity."

¹⁷⁹ *Id.* (to be codified at 11 U.S.C. § 365(n)(4)(A)).

¹⁸⁰ *Id.* (to be codified at 11 U.S.C. § 365(n)(4)(B)).

licensee and that the interests of the licensee should, therefore, prevail over the licensor's interest in reorganizing.¹⁸¹

Any licensee that chooses to retain his rights under the license is required to continue making royalty payments to the licensor as provided under the agreement.¹⁸² This, however, is no consolation to the licensor, who could have benefitted more had he been able to terminate an unprofitable license altogether and re-license those rights to a new licensee. If a percentage of the licensee's profits are handed over to the licensor, the licensor may not be disadvantaged unjustly if the licensee's activities are highly profitable, unless a higher percentage could be obtained from another licensee. However, if the licensee was only required to pay, for example, a yearly fee of \$20,000, the licensor loses if the licensee's business is reaping millions of dollars in profits annually. Of course, depending upon market demand, a set fee may yield more revenue to a licensor and, thus, be a more favorable alternative. On the other hand, if the set fee were substantially lower than the percentage fee that could be obtained from the current or a new licensee, the licensor would benefit greatly if he could reject the license or renegotiate the terms of the existing licensing agreement. Under applicable contract principles, the licensor and licensee are free to renegotiate the terms of the agreement if and when both sides agree to do so. However, under the protection of section 365(n), any incentive for the licensee to renegotiate is minimal, leaving the licensor with few options.

The extent to which the licensee must continue to fulfill his affirmative obligations under the license is another area of uncertainty under section 365(n).¹⁸³ Section 365(n)(1)(B) relieves the licensor of all performance obligations other than allowing the licensee to retain its rights under the license. On the other hand, while the licensee is specifically required to continue making royalty payments under section 365(n)(2)(B), the amendment is silent as to the licensee's remaining affirmative obligations. It has been presumed that under the license agreement the licensee will have to continue fulfilling his obligations, with the exception of those which are dependent upon the licensor's cooperation.¹⁸⁴ However, because this is an ambiguous point, there is much room for misinterpretation. The statute could be interpreted to only require that the licensee continue making royalty payments. Rejec-

¹⁸¹ H.R. 4657, *supra* note 26. In arguing that the amendment as proposed was overbroad, Hemnes indicated that in most types of licensing transactions, "outright termination of the non-bankrupt party's right to use licensed technology is unlikely to be fatal to the licensee." *Id.* at 36 (testimony of Thomas M.S. Hemnes).

¹⁸² Pub. L. No. 100-506, § 1(b) (to be codified at 11 U.S.C. § 365(n)(2)(B)).

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¹⁸⁴ *Id.* at 106 (statement of George A. Hahn).

tion could then be used as a defense, by claiming that the licensor's rejection rendered the agreement unenforceable, thus leaving the debtor-licensor without a remedy for the licensee's noncompliance with the remaining terms of the licensing agreement.¹⁸⁵ Conceivably, a licensee that obtains the software program's source code from the escrow agent can decipher it to determine how it functions. Once this has been achieved, an adventurous licensee could make improvements or substantial alterations in the program.¹⁸⁶ The licensor may be left with no remedy against such misappropriation.¹⁸⁷

Section 365(n) also conflicts with certain aspects of copyright law. The licensor may reject the contract, but if an exclusive licensee chooses to retain under section 365(n), the licensor cannot regain his technology for the term of the license. By allowing a licensee to retain his rights, regardless of his exclusivity and solely at his own option, the amendment overlooks the interests of the licensor in controlling the disposition of its invention.

The amendment, therefore, has several ramifications. First, it defeats the purpose of recording a transfer under the Copyright Act. The grant of an exclusive license constitutes a transfer of copyright ownership.¹⁸⁸ Prior to the enactment of section 365(n), if the exclusive software licensee duly registered the copyright, his rights in the program could have been protected against rejection under the Copyright Act.¹⁸⁹ However, the rights of a non-exclusive licensee, or of an exclu-

¹⁸⁵ *Id.* at 35-36. (testimony of Thomas M.S. Hemnes).

¹⁸⁶ *See supra* notes 41-47 and accompanying text.

¹⁸⁷ This potential issue was addressed by counsel, Gary Goldberger, during the hearings on H.R. 4657. In response, George A. Hahn, who testified on behalf of the National Bankruptcy Conference, admitted that there was nothing in the amendment, as then proposed, which explicitly addressed the question of what happened to the licensee's other contractual duties. He stated that "the courts will have to deal with that and it should be left for the courts to deal with it." *H.R. 4657, supra* note 26, at 106. Another witness, Marilyn Shea-Stonum, expressed concern over addressing this issue in detail and cautioned against creating an incentive for trustees to reject contracts. For instance, if a licensor knew that by rejecting, it could escape performing its duties yet be assured of continued performance from the licensee, it could have its cake and eat it too. *Id.* at 107. In response to a suggestion posed by Thomas Hemnes that the licensee's obligation to share improvements go forward, she indicated, "We found that somewhat ironic, that the person who hasn't breached the contract would be required to share post-petition improvements, when the bill explicitly relieves the person who has breached the contract from sharing its post-petition improvements. I think this is an area where the courts ought to do some work." *Id.*

¹⁸⁸ Under the 1976 Copyright Act, transfer of ownership includes "an assignment, mortgage, exclusive license, or any other conveyance, alienation, hypothecation of a copyright or of any of the exclusive rights comprised in a copyright, whether or not it is limited in time or place of effect, but not including a nonexclusive license." 17 U.S.C. § 101 (1982).

sive licensee that failed to register the transfer, would have been subject to avoidance under the Bankruptcy Code.¹⁹⁰ Amended section 365(n) treats all licensees the same, regardless of whether their rights were exclusive or non-exclusive, or whether the transfers were registered or unregistered. This works an injustice to licensors who are rendered powerless to dispose of their technology, even where no transfer has been effected legally due to the licensee's failure to register.

This brings us to a second point: the purpose of copyright protection. That purpose is to foster creativity and new ideas by providing a mechanism by which the manifestation of those ideas may be protected from misappropriation. Its effectiveness in promoting "the progress of science and the useful arts by securing for limited times to authors and inventors the exclusive rights to their respective writings and discoveries"¹⁹¹ may be diluted if creators lose faith in the ability of the copyright laws to protect their creations. Although section 365(n) seeks only to preserve the licensee's rights as laid out in the licensing agreement for the term of the contract, and does not attempt to divest the licensor of its copyrights, dilution may occur inadvertently. For instance, a software licensee who has opted to retain his rights in a licensing agreement that has fifteen years remaining before termination has ample time in which to alter the program, assuming the licensee is in possession of the source code. If the licensee manages to escape performing any contractual provisions requiring sharing improvements to the program with the licensor, the licensor will not benefit from the improvements. Additionally, if there was any illegal misappropriation, it will be difficult for the licensor to prove in court.¹⁹²

Finally, section 365(n) contravenes the fundamental policy underlying U.S. bankruptcy law to aid in the debtor's reorganization and treat all creditors equitably.¹⁹³ As discussed previously, the amendment fails to acknowledge or simply fails to consider the scenario in which the licensor's estate would benefit from rejection. This is especially true where assumption of the contract as originally drafted would be overly burdensome for the debtor to assume. This problem is further aggravated by the failure of section 365 to distinguish among the various types of licensing arrangements. While the exclusive licenses may be the ones that licensees most need to retain, due to their uniqueness and the difficulty in finding a replacement, exclusive licenses are also most likely to constrain the debtor's efforts at reorganization, particularly

¹⁹⁰ Hennes, *supra* note 50, at 354; 11 U.S.C. § 544(a)(1) (1982).

¹⁹¹ U.S. CONST., art. I, § 8, cl. 8.

¹⁹² See *supra* note 18 at 582 n.12.

where the technology is the debtor's most valuable asset.¹⁹⁴ Nonetheless, protection of a licensee's rights where they are exclusive is at least understandable. In many instances, however, there will most likely be an adequate replacement available for the licensee. In these situations, rejection should be allowed.

6.2 *The International Business Effects*

Although the maintenance of the United States' competitive advantage in the computer software industry was one of the primary factors which prompted reform, section 365(n) may not produce the desired result. While the amendment's application will allow domestic and foreign licensees to feel secure entering licensing agreements with software licensors, licensors may not feel equally comfortable. This is due, in part, to the inability of licensors to revoke a licensee's right to continue using the licensed program under the terms of the agreement, even where doing so would be crucial to aiding the debtor's efforts to reorganize. Although section 365(n) will similarly affect domestic and international licensing involving domestic intellectual property, the negative effects may be more apparent in the international arena due to the interest in maintaining U.S. competitiveness in the computer industry. Hence, despite the logical expectation that section 365(n) will make licensing a more attractive opportunity for all licensees, and thereby encourage technology flow, this objective may not be achieved if there is reluctance on the part of potential licensors.

Increased reluctance on the part of licensors may result from fear of losing control over the disposition of their technology upon bankruptcy and the possible consequences flowing from this loss of control, especially if the licensee is a potential foreign competitor. For instance, despite provisions to maintain confidentiality, a licensee could nonetheless continue to reap financial rewards from the licensed software by developing, manufacturing and marketing new products in its subsidiaries abroad.¹⁹⁵ Of course, the same scenario is equally possible in a purely domestic transaction. In this latter situation, however, the licensor has a greater degree of control and ease in monitoring a licensee's activities on a regular basis.¹⁹⁶ The complications that arise in the international context, such as obtaining evidence in an action and securing recognition for the licensor's product, would be minimized in a domestic action. Thus, while a foreign licensee continues to profit from

¹⁹⁴ H.R. 4657, *supra* note 26, at 40 n.13 (testimony of Thomas M.S. Hemnes).

¹⁹⁵ See *supra* notes 45-52 and accompanying text.

¹⁹⁶ See *supra* note 39.

the licensor's creation, the licensor is forced to suffer the consequence of having attempted to increase his own expertise in the field or in licensing his ideas or products to foreign parties in need of basic know-how.

Placing the weight of the risks entirely on the licensor may thus decrease the attractiveness of entering into international license agreements. Because there are numerous potential licensees in the United States, there may not be a substantial loss to a software licensor who chooses not to engage in foreign licensing. This assertion is buttressed by the fact that small start-up businesses and individual licensors do not have the financial resources necessary to extensively monitor and maintain a licensed software product that is located overseas.¹⁹⁷ At the outset, individual licensors are primarily interested in finding a licensee who will be willing to test a new idea which may or may not go anywhere. After balancing the speculative nature of such an endeavor—the additional time and costs involved and the lost opportunities that may result from avoiding foreign licensing—the safest route may be to avoid them altogether if equally attractive opportunities exist domestically. Ironically, section 365(n) was designed with the purpose of protecting the smaller businesses, as those are the ones in need of protection.¹⁹⁸ While the possibility of bankruptcy is not a point dwelled upon in most business ventures, the uncertainties and continuous fluctuations of the computer industry render the consideration of such possibility a reasonable one.

In the international context, it is probably unlikely that licensing activities will decrease markedly because of the economic necessity for the U.S. software industry to engage in reciprocal licensing with technologically advanced nations such as Japan. Software licensors can minimize their risks from these uncertainties by taking the necessary contractual precautions. For instance, licensors could refuse to grant a licensee access to the source code under any circumstances, or refuse to place the source code into escrow. Licensors can lease out software programs for shorter terms, renewable upon the end of the term. Section 365(n) will not eliminate the need to devise innovative methods of protecting a technology client's interests. The amendment only reverses the positions of licensor and licensee, with the dilemma now in the licensor's hands rather than the licensee's.

7. CONCLUSION

The injustices that the rejection of a software or other technology

¹⁹⁷ *Id.*

licensing agreement can inflict upon a licensee were relevant issues that needed to be addressed. They were also issues of questionable immediacy. Had the courts been permitted to further refine the judicial balancing test without legislative interference, these problems might have been alleviated on their own. Nonetheless, the industry fears, which stemmed largely from the Fourth Circuit's decision in *Lubrizol*, were able to push through Congress an amendment which may not prove to be the cure-all it was intended to be.

The Intellectual Property Bankruptcy Protection Act does not strike the desired balance between the interests of a licensor and licensee to a software licensing agreement. By allowing licensees the option to retain their licensed interests in software in every situation where rejection has been approved by a court, section 365(n) alleviates the problems of the licensee by inadvertently creating burdens for the licensor. Furthermore, it conflicts with fundamental policies underlying U.S. bankruptcy and copyright laws.

The effects of section 365(n) are presently unknown, as the provision has been in effect for only a short time. From this brief analysis, however, it is reasonable to speculate that additional fine-tuning of the amendment may be in store. Additional fine-tuning should create a more balanced approach by accounting for the interests of both licensor and licensee without sacrificing the rights of either party. Without some modifications by the legislature or creative interpretation by the courts, section 365(n) may create a disincentive for licensors to enter licensing agreements. Rather than remedying the software licensing dilemma, section 365(n) could still have a potential chilling effect on software licensing transactions and do nothing to improve U.S. competitiveness in technology.