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The Rejection of Executory Contracts under the Intellectual Property Bankruptcy Protection Act of 1988

John J. Fry

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**I. INTRODUCTION**

The development of technology-intensive products and industries is an important component of American industrial policy, especially in light of what has been portrayed as the decline of American manufacturing prowess.\(^1\) Consistent with this view, the need to revive American industrial "competitiveness" by fostering the development of new technologies and processes has received considerable attention.\(^2\) This objective is shared by federal intellectual property law, which encourages innovation by protecting what is often a substantial investment in the development of new technologies.\(^3\)

The creation of a new process or technology is only a starting point, however. To be useful, the new technology must be commercialized so that it is workable and profitable in the marketplace.\(^4\) Commercialization is often accomplished through license agreements in which the owner of intellectual property retains his ownership in the licensed property, but allows the licensee to utilize the intellectual property in a manner consistent with the terms contained in a license agreement. A potential

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\(^3\) The sources and objectives of intellectual property protection were recently summarized by Congress as part of its consideration of the Intellectual Property Antitrust Act:

> Congress enacted the federal intellectual property laws pursuant to its constitutional power to promote the progress of science and useful arts. See U.S. Const. 1, Sec. 8, cl. 8. The intellectual property laws increase social welfare by encouraging investment in innovation. By recognizing intellectual innovations as property, these laws provide inventors, as well as authors and other artists, with exclusive rights to the use of their inventions and original works for a limited time. These rights enable innovators to capture some of the economic rewards of their efforts.


roadblock to successful commercialization in the context of intellectual property licensing is the bankruptcy of the licensor, especially where the licensor elects to reject the license agreement under 11 U.S.C. §365. Recent court decisions have been viewed as having a chilling effect on the licensing process by allowing a bankrupt intellectual property licensor to reject an executory license agreement, thereby depriving the licensee of access to the technology which is the subject matter of the agreement.

In response to these concerns, Congress, in October of 1988, enacted the Intellectual Property Bankruptcy Protection Act [the Act]. The Act is intended to “promote the development and licensing of intellectual property by providing certainty to licensees in situations where the licensor files bankruptcy and seeks to reject the license as an executory contract” by providing the licensee an “assurance of being able to continue to use the licensed intellectual property after rejection, while debtors/licensors will still be able to free themselves of burdensome obligations.” As defined by the Act, the term intellectual property encompasses trade secrets, inventions, processes, designs, and plants or plant varieties, including related patents and patent applications. Confidential research and development information, works of authorship, and mask works are also protected. Trademarks, trade names, and service marks are deliberately excluded from the definition due to a Congressional determination that further study is required before enacting provisions dealing with these areas.

5 11 U.S.C. § 365 (1988). Section 365 codifies the circumstances under which a trustee or debtor in possession is empowered to reject an executory contract as part of a bankruptcy action.


An executory contract is generally considered to be one in which performance is due, to some extent, by both sides. See infra note 27 and accompanying text. For a discussion of executory contracts in the context of intellectual property licensing, see infra notes 82-98 and accompanying text.


8 Id. The Senate perceived a similar objective in the adoption of the Act. As stated by the Senate, the purpose of the Act “is to make clear that the rights of an intellectual property licensee to use the licensed property cannot be unilaterally cut off as a result of the rejection of the license ... in the event of the licensor's bankruptcy.” S. Rep. No. 505, 100th Cong., 2d Sess. 1 (1988).

9 The Act adds a new subsection to 11 U.S.C. § 101 as follows:

(52) 'intellectual property’ means-
(A) trade secret;
(B) invention, process, design, plant, or plant variety, including patents or patent applications thereon;
(C) confidential research or development information;
(D) work of authorship, including copyrights therefor; or
(E) maskwork; 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.


The Act adds a new subsection to 11 U.S.C. §365 which allows the licensee of intellectual property under an executory contract to choose between two options in those situations where the contract is rejected as part of the licensor's bankruptcy. The licensee's first option is to accept

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12 The text of 11 U.S.C. § 365 was amended to include the following:
(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 nonbankruptcy law, or an agreement made by the licensee with another entity; or
(B) to retain its rights (including a right to enforce any exclusivity provision of such contract, but excluding any other right under applicable nonbankruptcy law to specific performance of such contract) under such contract and under any agreement supplementary to such contract, to such intellectual property (including any embodiment of 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

(2) If the licensee elects to retain its rights, as described in paragraph (1)(B) of this subsection, under such contract-
(A) the trustee shall allow the licensee to exercise such rights;
(B) the licensee shall make all payments with respect to such rights due under such contract with respect to the rights retained for the duration of such contract and for any period described in paragraph (1)(B) of this subsection for which the licensee extend such contract; and
(C) he licensee shall have been deemed to waive-
(i) any right to 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.

(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; and
(B) not interfere with the rights of the licensee as provided in such contract, or any agreement 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.

(4) Unless and until the trustee rejects such contract, 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-
(i) perform such contract; or
(ii) provide to the licensee such intellectual property (including any embodiment of such intellectual property to the extent protected by applicable nonbankruptcy law) held by the trustee; and
(B) not interfere with the rights of the licensee as provided in such contract, or any agreement supplementary to such contract, to such intellectual property (including such embodiment), including any right to obtain such intellectual property (or such embodiment) from a third entity.
the rejection as terminating the contract. This option was available before passage of the Act. Secondly, the Act allows the licensee to retain its intellectual property rights under the contract, including rights to any embodiments of the property, to the extent that the rights existed immediately prior to commencement of the case. The rights can be retained for the duration of the contract and for any period which the licensee could, as of right, extend the contract. If the licensee elects to retain its contract rights, it is required to make royalty payments as required under the contract, and waives any right to setoff of damages under the contract and claims for administrative expenses under 11 U.S.C. §503(b). The trustee must allow the licensee continued access to the underlying intellectual property in those cases where the licensee elects to retain its rights to the property in response to rejection by the trustee. The trustee must also perform in accordance with the terms of the license agreement during the period prior to rejection.

In order to gain a more complete understanding of the Intellectual Bankruptcy Protection Act and its impact, it is useful to consider the Act in terms of the background, both legal and commercial, from which it developed. This background includes the underpinnings of bankruptcy law, the economic forces which make intellectual property licensing an attractive method for accomplishing technology transfer, and the case law which generated an interest in statutory reform.

II. EXECUTORY CONTRACTS IN BANKRUPTCY

Modern bankruptcy law can be viewed as a mechanism which is designed to promote two often divergent goals. When considered in the context of a business bankruptcy, one such goal is to keep firms in operation when it is societally advantageous to do so. Secondly, bankruptcy law operates to protect the creditor based on the assumption that the bankrupt’s estate is insufficient to pay each creditor in full. Thus, the Bankruptcy Code provides for a distribution process which determines who, among the creditors, should get what, and in what order. This assures an orderly means for the distribution of the bankrupt’s estate.

14 U.S.C. § 365(n)(1)(B) (1988). Potential embodiments include, but are not limited to, prototypes containing the licensed intellectual property, genetic material needed to produce certain biotechnological products and computer program source codes. The licensee is to have access to the embodiment as it existed on the day of the bankruptcy filing. S. REP. 505, supra note 8, at 10.
The affairs of the estate are administered by a trustee who has a fiduciary duty to represent the estate and can sue or be sued for matters dealing with his duty as trustee. In actions for liquidation of the estate under Chapter 7, "[t]he trustee's principal duty is to collect and reduce to money the property of the estate for which he serves, and to close up the estate as expeditiously as is compatible with the best interests of parties in interest." In a proceeding for reorganization under Chapter 11, the debtor will usually retain control of his business while the reorganization is under way. A debtor performing in this capacity is referred to as the debtor in possession. The debtor in possession acts in a capacity very similar to that of a trustee and is, for all intents and purposes, equivalent to a trustee. Thus, the two terms are often used interchangeably.

The provisions whereby the trustee can reject or assume executory contracts are contained in 11 U.S.C. § 365. Rejection occurs when, with the approval of the court, the trustee disaffirms the estate's obligation to perform under an executory contract. An executory contract is generally considered to be one in which performance is due, to some extent, by both sides.

The power of rejection benefits the estate by relieving the bankrupt of ongoing duties under an executory contract where disaffirmance would be advantageous to the bankrupt. Rejection constitutes a breach of the contract immediately preceding the filing of the debtor's petition so as to treat the other contracting party as a general unsecured creditor. Rejection prevents the contracting creditor from obtaining specific performance as to the executory portions of the contract, limits the cred-

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23 S. Rep. No. 989, 95th Cong., 2d Sess. (1978). The duties of the trustee are set forth by 11 U.S.C. § 704. Section 704 also provides that the trustee has a duty to account for all property received, investigate the financial affairs of the debtor, examine and object to improper claims, oppose the discharge of the debtor, furnish information to parties in interest, and prepare a final report concerning the administration of the estate.
25 The rights, powers, and duties of a debtor in possession are set forth in 11 U.S.C. § 1107 (1978), which provides that "a debtor in possession shall have all the rights, other than the right to compensation under section 330 of this title, and powers, and shall perform all the functions and duties" of a trustee. Section 1107 also provides that the debtor in possession need not perform an investigation into the affairs of the debtor as is required of a trustee.
29 11 U.S.C. § 365(g) (1988). Collier on Bankruptcy Para. 365.08 (15th Ed. 1985). Section 365 also allows the trustee to assume executory contracts, with the approval of the court, provided that the trustee shows that past non-performance has been cured, compensates the other party for earlier defaults, and can assure future performance. 11 U.S.C. § 365(b)(1) (1978).
itor’s claim to damages for breach of contract,\textsuperscript{30} and is not the equivalent of rescission.\textsuperscript{31} Rather, rejection constitutes a breach of contract, and the injured party is treated as a general unsecured creditor and is entitled to assert a claim for damages caused by the breach.\textsuperscript{32}

\section*{III. Intellectual Property License Agreements}

The Intellectual Property Bankruptcy Protection Act operates to clarify the rights of parties to intellectual property license agreements in situations where the licensor seeks to reject the license agreement. Implicit in the adoption of the Act is a recognition of the impact of license agreements in facilitating the commercialization of new technology. An understanding of the inventive and innovative processes as applicable to intellectual property license agreements will provide a useful background for evaluating the operation and policy implications of the Act.\textsuperscript{33}

Invention\textsuperscript{34} and innovation\textsuperscript{35} are key factors in the ongoing process of technological change. For an invention to have further economic impact, it must be transformed through the innovative process into products that pass the tests of technical and economic feasibility, and ultimately, market acceptance.\textsuperscript{36} Congress has recognized that the innovative “process


\textsuperscript{32} Murphy, 694 F.2d at 174.


\textsuperscript{34} Invention is a term of art which describes the observation or discovery of new scientific principles which expand the scope of knowledge or open new areas for scientific inquiry. B. Majumdar, Innovations, Product Developments, and Technology Transfer 35 (1982). See also C. Freeman, The Economics of Industrial Innovation 7 (2d ed. 1982); R. Rothwell & W. Zegveld, supra note 33, at 7.

\textsuperscript{35} Innovation is a term of art used to describe process which transforms the principles underlying an invention into a useful product or services. B. Majumdar, supra note 34, at 35. See also C. Freeman, supra note 34, at 7; R. Rothwell & W. Zegveld, supra note 33, at 47. The scope of technological change encompassed by innovations varies significantly. Innovations can be classified as radical innovations which change or create whole industries, systems innovations (such as communications networks) which take many years and millions of dollars to accomplish, and incremental innovations, which are small but important improvements to products, processes, or services. F. Betz, Managing Technology, Competing Through New Ventures, Innovation, and Corporate Research 7 (1987).

\textsuperscript{36} G. Rosegger, supra note 2, at 109; C. Freeman supra note 34, at 7.
begins with an inventive concept and must proceed through an expensive and risky series of steps including research, development, manufacturing, and marketing. At each step, both money and additional refinement of the idea are required. This process and its attendant costs are well documented:

R&D (Research and Development) projects move toward commercialization through several roughly defined stages: a pre-laboratory phase, laboratory work (to garner scientific and engineering knowledge), engineering (to seek a basis for economic evaluation), pilot plant or prototype (to refine and prove the economic evaluation), and full scale production. Each stage of the commercialization process is much more costly than the one preceding it—as a rule of thumb, four or five times more costly. Thus, if laboratory work costs $1 million, engineering may cost $5 million, a pilot plant perhaps $20 million, and production facilities $100 million.

In light of the extensive investment, in both time and money, which is required to launch a new product, the attributes of the product itself must be carefully considered. The product must meet the needs of the marketplace in terms of its function, price, quantity, location, timing, and presentation. Furthermore, the financing, expertise, and additional product refinements necessary to meet these needs are often only available through the participation of persons other than the original inventor. For example, an inventor may lack the resources or the expertise to manufacture a new product so as to meet anticipated demand in a cost effective manner. An enterprise with manufacturing expertise, on the other hand, may be unable to develop a desired new product within the period of time necessary to meet an expected market window. At the same time, a warehouse filled with completed products represents a significant loss if it is not made available to potential customers through appropriate marketing and distribution channels.

37 S. REP. No. 505, supra note 8, at 3. The path from invention to social application is often long and hazardous. C. FREEMAN, supra note 34, at 7.
38 Lee, Fisher, & Yau, Getting Things Done—Is Your R&D on Track?, HARV. BUS. REV., Jan.-Feb. 1986, at 35-36. The pharmaceuticals industry provides an excellent example of a research intensive industry. The Pharmaceutical Manufacturers Association estimates the cost of bringing a new drug to market to be over $100 million. This investment begins when testing commences and continues until the Food and Drug Administration grants approval for marketing. J. McLaughlin, Vice President Governmental Affairs, Genentech, Inc., Statement Before the Subcommittee on Courts and Administrative Practice, Committee on the Judiciary, United States Senate on S. 1626, at 2 (June 10, 1988). The biotechnology industry provides an excellent example of the risk associated with these high development expenditures. In 1988, at least 24 biotechnology companies filed for bankruptcy protection. Biotechnology executives also believe that within 10 years roughly half of the 500 U.S. companies in the biotechnology business will fail, merge, or enter into a cost sharing agreement. This problem is due, in large part, to the fact that these businesses cannot raise the necessary capital or develop a marketable product. Naj, Clouds Gather Over the Biotech Industry, Wall St. J., Jan. 30, 1989, at B1, col. 3.
39 F. BUTTRELL, supra note 4, at 13.
40 S. REP. No. 505, supra note 8, at 3.
The element of risk plays a significant role in an organization's decision concerning the innovative process, especially as applied to the development of new technology.\textsuperscript{41} Of all the areas to which resources can be allocated, research and development investments have the longest time frame, the least certain outcome, and face the least well-defined competitive environment.\textsuperscript{42} Although R&D expenditures are subtracted from current earnings, the rewards, if they materialize at all, will contribute only to earnings realized in the distant future.\textsuperscript{43} Thus, the generation of major technological advances often ranks quite low compared to other means for the achievement of an organization's business goals, because it involves heavy investment and high risks, not only for the firm, but also the for the personal careers of the decision makers.\textsuperscript{44} Although technological progress is one of the hallmarks of a healthy economy, risk aversion makes competitive pressures and external events, rather than an inherent organizational proclivity for innovation, more likely stimuli for major innovative efforts.\textsuperscript{45}

The development of a new product or service presents its own set of risks, especially due to uncertainty as to whether technical and market goals will be achieved.\textsuperscript{46} A major uncertainty in most R&D investments is whether the research phase will produce a viable product.\textsuperscript{47} Not only must the product work,\textsuperscript{48} it must compete successfully with other products. In order to do so effectively, the product must possess the attributes necessary for successful market entry.\textsuperscript{49} The absence of any one of these attributes can spell failure for the new product and result in the loss of resources already invested in the project as well as the potential gains realized by a successful product introduction. The extensive risks are highlighted by a classic study by the market research firm of Booz, Allen, and Hamilton which found that in fifty-one major U.S. companies only two percent (2\%) of new products were commercially successful, with almost ninety percent (90\%) failing prior to market testing.\textsuperscript{50}

\textsuperscript{41} See G. Rosseger, \textit{supra} note 2, at 170.
\textsuperscript{42} Lee, Fisher, & Yau, \textit{supra} note 38, at 34.
\textsuperscript{43} Id. at 34.
\textsuperscript{44} G. Rosseger, \textit{supra} note 2, at 170.
\textsuperscript{45} Id. at 171.
\textsuperscript{46} See Lee, Fisher, & Yau, \textit{supra} note 38, at 35.
\textsuperscript{47} Hodder & Riggs, \textit{Pitfalls in Evaluating Risky Projects}, \textit{Harv. Bus. Rev.}, Jan-Feb 1985 at 134. In the pharmaceuticals industry, for example, thousands of compounds are often tried before a successful one is uncovered. J. Lowe & N. Crawford, \textit{Innovation and Technology Transfer for Growing Firms} 37 (1984).
\textsuperscript{48} Note that the term "work" or "not work" is an oversimplification. This issue is one of degree. The standards of performance, operating conditions, and cost associated with a product are factors which must be considered. Important also is the extent to which the innovation will satisfy the relevant technical criteria without increased cost of development, production, or operation. C. Freeman, \textit{supra} note 34, at 149.
\textsuperscript{49} F. Buttrell \textit{supra} note 39 and accompanying text.
\textsuperscript{50} J. Lowe & N. Crawford, \textit{supra} note 47, at 37. Lowe and Crawford indicate that as many as ninety-one percent (91\%) of new product ideas are technically...
These factors have fostered the growth of technology licensing as a means of promoting business development and company growth. Technology licensing is particularly attractive as a mechanism for growth because it allows two sources of resources to be tapped by providing a means by which those with technical superiority and those who have intimate market knowledge can join forces. License agreements often are used to transfer a wide variety of intellectual property, including patents, copyrights, trade secrets, and know-how. License agreements are not generally standardized, and a particular transaction is the product of the circumstances of the licensor, the licensee, and other interested parties. The various facts and circumstances which surround a particular license agreement can play an important role in shaping the agreement. Thus, it has been recognized that license agreements vary widely both in scope and scale however, and can comprise no more than the use of a particular patent or agreement in a process in some cases. At the other end of the spectrum, licensing agreements for industrial processes can involve the transfer of hundreds of patents, the training of large numbers of personnel, and large scale investment.

In complex transactions, a license agreement can be described as a partnership which governs the working relationship between the licensor and licensee. Although the obligations of the parties can be expected to vary successful, although the study did not consider commercial success. This highlights the fact that commercial forces can play an important role in shaping the success of an idea that can be considered technically successful. Note, however, that statistics which attempt to highlight the failure rate of attempted innovations should be approached with caution. These generalizations are usually based on the experience of a small number of firms over a particular period of time. The relevance of the figures is directly related to the stage of innovation at which the measurements are made. The higher failure rates generally refer to determinations made before significant expenditures have been expended on commercialization, and well before commercial launch. C. Freeman, supra note 34, at 148.

51 J. Lowe & N. Crawford, supra note 47, at 1.
54 J. Lowe & N. Crawford, supra note 47, at 2. See generally T. Hemnes, Testimony Before the Subcommittee on Courts and Administrative Practice of the Senate Committee on the Judiciary regarding S. 1626 (June 10, 1988) (Hemnes discusses license agreements typical of those used in distribution agreements and in the computer software industry. He emphasizes that typical license agreements can provide for significant interaction between the parties. Cross-licensing, by which the parties exchange technology in both directions, is common. Terms which provide for technical support and training are also common). For an example of a less complex license agreement dealing with a single patent, see generally Lubrizol Enter. v. Richmond Metal Finishers, 756 F.2d 1043 (4th Cir. 1985), cert. denied, 475 U.S. 1057 (1986).
55 J. Lowe & N. Crawford, supra note 47, at 2. Note that the license agreement can be one of several agreements which describes the working relationship between the parties. S. Rep. No. 505, supra note 8, at 9.
with the scope and terms of the agreement, the licensor and licensee can be defined in general terms. The licensor will typically agree to transfer to a purchaser (the licensee) the rights to use intellectual property which is otherwise protected and will typically provide the licensee with information sufficient to use the product or process. The emphasis in a technology license agreement is on the successful commercial application of the technology. To this end, the licensor has a vested interest in supplying information and knowledge sufficient to ensure the successful application of the technology. In return, the licensee often pays a fee which includes both up front and royalty payments. In many cases, however, the agreement takes the form of a cross licensing agreement in which the cross transfer of technology accounts for some or all of the consideration. The licensee normally contracts to use the licensed technology in such a way as to benefit both parties. This generally requires that the licensee agree to use a reasonable effort to develop business based on the license.

Technology licensing can be used to promote the different business needs of the parties in such a way as to benefit the parties as well as society in general. These benefits accrue in a number of ways. Reasons for granting licenses include allowing for growth without sacrificing ownership of intellectual property or overextending a firm's management, the exploitation of alternative markets, the realization of royalty income, and the reduction of risk. A similar set of concerns governs the acceptance of licenses. A licensee can, through the licensing process, grow despite income, expertise, and time constraints by adding new products, improving existing ones, improving production efficiency, and reducing the risk, time, and expense associated with full scale research and development projects. In effect, the licensee and licensor act as partners to exploit the market on the premise that both firms can gain substantial growth at a lower cost than they would be able to if each acted independently. The risks to both parties are therefore reduced, while the total returns are likely to be higher than if the parties had acted separately.

56 J. LOWE & N. CRAWFORD, supra note 47, at 2.
57 Id. See C. FREEMAN, supra note 34, at 4 for a discussion of the importance of the production and dissemination of knowledge in the investment process.
58 J. LOWE & N. CRAWFORD, supra note 47, at 3.
59 McLaughlin, supra note 38, at 3.
60 See generally B. MAJUMDAR, supra note 34; E. LOVELL, DOMESTIC LICENSING PRACTICES, A SURVEY (1968) (presenting a survey of 165 senior executives of a cross section of U.S. firms concerning the motivations, methods, advantages, pitfalls, and impact of licensing in the operation of their organizations); Paglia, Basic Considerations in Licensing from the Business Perspective, in Technology Licensing 1987, at 99 (1987).
61 See generally B. MAJUMDAR, supra note 34; E. LOVELL, supra note 60.
62 J. LOWE & N. CRAWFORD, supra note 47, at 3.
63 Id. Although the potential risks are reduced, it is also true that each party's share of the total return will be reduced. See S. BERG, J. DUNCAN, & P. FRIEDMAN, JOINT VENTURE STRATEGIES AND CORPORATE INNOVATION 10-11 (1982); ARNOLD, WHITE, DURKEE, supra note 52, at 16. A firm's licensing decision is generally made in this risk-rate of return context. J. LOWE & N. CRAWFORD, supra note 47, at 44.
The benefits which accrue to a licensor can be significant. Although financial constraints are clearly an important restriction on the activities of a smaller firm, some have argued that constraints in terms of management's time are even more significant. The outward licensing process allows limited management resources to be focused on the firm's more pressing, core functions. The granting of non-exclusive licenses based on market segments presents an opportunity to expand innovative products or functions to new areas of application. Thus, an innovator who has identified more than one area in which his invention may be applied can seek partners in each area without risking the probability that one developer's narrow focus will deny him the benefits of development in another area. This is especially true where a firm's research has led to ideas which are not immediately appropriate to its own product lines, where the new technology provides for "spin offs" only tangentially related to the company's focus, or where a company's manufacturing facilities are insufficient to meet demand. License agreements based on geographical area likewise present a mechanism by which an innovation can be applied or distributed in geographical areas which the innovator would find it difficult to service. Licensing also allows small startup companies to generate revenues to fund their research, testing, and capital equipment acquisition activities while still maintaining ownership of the company's intellectual property which, in the case of a high technology startup company, is often its most significant asset. In this way, a small start up has a better chance to attract the additional capital needed for continued growth.

Footnotes:

64 J. LOWE & N. CRAWFORD, supra note 47, at 1.
65 The transaction costs inherent in entering into and monitoring the license agreement must be considered, however. S. BERG, J. DUNCAN, & P. FRIEDMAN, supra note 63, at 10-11. This is especially true of firms with little experience in identifying potential licensees and undertaking license agreements. J. LOWE & N. CRAWFORD, supra note 47, at 45. Thus, the need for in-house personnel experienced in licensing issues or the use of an attorney is often recognized. G. FREEDMAN, THE PURSUIT OF INNOVATION 311 (1988).
66 S. REP. No. 505, supra note 8, at 3.
67 J. LOWE & N. CRAWFORD, supra note 47 at 45, 171; E. LOVELL, supra note 60, at 12, 13;
68 Hearings on S. 1626 Before the Subcommittee on Courts and Administrative Practice of the Senate Judiciary Committee, (June 10, 1988) [hereinafter Hearings] (statement of S. Mendell, Chairman of the Board and CEO, Xoma Corp.). See also ARNOLD, WHITE, & DURKEE, supra note 52, at 13. For a discussion of the consideration influencing licensing decisions in the international arena, see generally Richards, Licensing in the International Field, DOMESTIC AND FOREIGN TECHNOLOGY LICENSING 1984, at 189 (1984).
70 J. McLaughlin, supra note 38, at 3. Most new, high technology companies finance their operations through revenues obtained by a combination of licensing and equity capital. These revenues are used to fund the company's research and development activities and to acquire laboratory equipment, computers, manufacturing facilities, and other capital equipment. Id. For a discussion of venture capital and other methods of providing funding for innovative ventures, see generally G. YOUNG, VENTURE CAPITAL IN HIGH-TECH COMPANIES (1985) (discussing the role of venture capital in the electronics industry); R. HISRICH, ENTREPRENEURSHIP, INTRAPRENEURSHIP, AND VENTURE CAPITAL (1986) (discussing the role of venture capital in stimulating economic development and the growth of new firms).
introduction can also be reduced. For example, it is often difficult to establish the exact value of an idea before it is introduced to the marketplace.\textsuperscript{71} Through licenses, the new ideas can be incorporated into a product and the financial risk shared between the licensor and licensee. If the product is unsuccessful, the licensee absorbs the loss of manufacturing costs but is not required to pay for an idea that was not successful, while the licensor receives a share of the benefits realized through a successful innovation.\textsuperscript{72} Thus, prudent licensing allows the owner of intellectual property to develop its technology efficiently and in a way that maximizes its commercial potential.\textsuperscript{73}

A similar set of benefits can accrue to a successful licensee. In general, license agreements provide a means by which a licensee can grow despite income and time constraints.\textsuperscript{74} Like the licensor, the licensee can use the license as a basis for the generation of new products, improvements in existing products, or for entry into new markets.\textsuperscript{75} License agreements can also be used to reduce the licensee’s investment in the time and expense of an R&D project. The time element is especially important where product life cycles are short and rapid entry into the market is a necessary component of successful commercialization.\textsuperscript{76} The risk of an unsuccessful R&D venture can also be reduced by gaining access to technology which has already been tested and, in some cases, proven to be commercially successful. The licensing process can minimize both technical and financial risk by licensing an established process rather than relying on the company’s own engineering staff to develop a competitive technology.\textsuperscript{77} The larger the investment at stake, the greater the incentive there is to adopt a proven technology.\textsuperscript{78} An increase in production efficiency through the use of improved production or processing technology is another benefit which can be obtained through a license agreement.\textsuperscript{79} These benefits make the licensing of intellectual property an attractive means of acquiring new products and processes.

\textsuperscript{71} Hearings, supra note 68 (statement of J. Pickitt, President of the Computer and Business Equipment Manufacturers Association).

\textsuperscript{72} Hearings, supra note 68, at 3 (statement of J. Pickitt).

\textsuperscript{73} Hearings, supra note 68, at 3.

\textsuperscript{74} J. Lowe & N. Crawford, supra note 47, at 1. See also E. Lovell, supra note 60, at 16.

\textsuperscript{75} See J. Lowe & N. Crawford, supra note 47, at 44; E. Lovell, supra note 60, at 18.

\textsuperscript{76} J. Lowe & N. Crawford, supra note 47, at 44. See also E. Lovell, supra note 60, at 20.

\textsuperscript{77} This is especially true where experienced and proven research people in a given area are difficult to come by. Arnold, White, & Durkee, supra note 52, at 22. J. Lowe & N. Crawford, supra note 47, at 44.; E. Lovell, supra note 60, at 21.

\textsuperscript{78} E. Lovell, supra note 60, at 21. Note that the goal of a development effort is to generate the most efficient means of accomplishing a particular function. A previous, successful development effort may have obtained intellectual property protection for a given technical approach. Thus, in the absence of a license agreement, a promising technical approach may be foreclosed. See Arnold, White, & Durkee, supra note 52, at 21.

\textsuperscript{79} See, e.g., Lubrizol Enter. v. Richmond Metal Finishers, 756 F.2d 1043 (4th Cir. 1985), cert. denied, 475 U.S. 1057 (1986), in which Lubrizol Enterprises entered into a licensing agreement concerning the use of a metal finishing process which had been patented by Richmond.
The rejection of executory contracts is governed by 11 U.S.C. § 365. Two areas of litigation under § 365 have proven particularly troublesome, especially when considered in the context of intellectual property license agreements. The definition of an executory contract is an area of some uncertainty. Additionally, a unified principle for determining the circumstances under which the court will approve a trustee's rejection of an executory contract has frequently proven to be a matter of contention. The term 'executory contract' is not defined in the Bankruptcy Code. This omission was intentional, and is a result of congressional concern that because a precise definition of the term is difficult, "any succinct statutory language risks an unintended omission or inclusion."

The legislative history, however, suggests that an executory contract is one in which performance of the contract remains due to some extent on both sides. Many courts have interpreted the legislative history to indicate an implicit congressional acceptance of the definition proffered by Professor Countryman, who defines an executory contract as "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other." Countryman's analysis concluded that the requirement of continuing obligations by both sides was a fundamental component of an executory contract in the bankruptcy context. Countryman also recognized that the "usual patent license, by which the patentee-licensor authorizes the licensee to exercise some part of the patentee's exclusive right to make, use and vend the patented item in return for..."
payment of royalties, ordinarily takes the form of an executory contract.\textsuperscript{85}

The Countryman view has gained wide acceptance and is often applied to patent and other intellectual property licenses. Hence, intellectual property license agreements are generally found to be executory. For example, \textit{Lubrizol Enterprises v. Richmond Metal Finishers}\textsuperscript{86} presents a contract in which Richmond, prior to its bankruptcy, granted Lubrizol a license to use a patented industrial process. The contract was found to be executory under 11 U.S.C. § 365(a) in light of the court's determination that continuing performance by both parties was required and that failure of either party to perform these obligations would constitute a material breach of the contract.\textsuperscript{87} Richmond had several ongoing duties under the terms of the agreement. Most importantly, Richmond owed Lubrizol the continuing duty of notifying Lubrizol of further licensing of the process and of reducing Lubrizol's royalty rate commensurate with more favorable licenses granted to others.\textsuperscript{88} Richmond was also under an ongoing duty to notify Lubrizol of patent infringement suits as well as to defend these suits and to indemnify Lubrizol for losses arising out of misrepresentation or breach of warranty by Richmond.\textsuperscript{89} Lubrizol, the licensor, was under an ongoing obligation to account for and pay royalties over the life of the agreement.\textsuperscript{90}

A similar contract which governed an exclusive computer software license was held to be executory in \textit{Fenix Cattle Company v. Silver (In re Select-A-Seat Corp.)}.\textsuperscript{91} The court found that due to the exclusive nature of the agreement, Fenix, the debtor-licensor, was under a continuing obligation not to sell its software packages to other parties.\textsuperscript{92} The court stated that violation of this obligation would constitute a material breach of the agreement.\textsuperscript{93} The licensee's duty to make royalty payments was held to make the agreement executory from the perspective of the licensee.


\textsuperscript{86} 756 F.2d 1043 (4th Cir. 1985), cert. denied, 475 U.S. 1057 (1986).

\textsuperscript{87} Id. at 1045.

\textsuperscript{88} Id. This type of agreement is common in license agreements and is often referred to as a “Most Favored Nation” or “Most Favored Licensee” clause. See Cascio, \textit{Key Provisions for Technology Licensing Agreements}, TECHNOLOGY LICENSING 1987 at 159, 161 (1987); Kline, \textit{Key License Clauses}, TECHNOLOGY LICENSING 1987 at 175, 177 (1987).

\textsuperscript{89} Lubrizol Enter. v. Richmond Metal Finishers, 756 F.2d 1043, 1045 (4th Cir. 1985), cert. denied, 475 U.S. 1057 (1986).

\textsuperscript{90} Id. at 1046. Where all elements of performance have been completed, leaving only an obligation for the payment of money, a contract is not executory. In the Matter of Smith Jones, Inc., 26 Bankr. 289, 292 (D. Minn. 1982); Lubrizol Enter. v. Richmond Metal Finishers, 756 F.2d 1043, 1046 (4th Cir. 1985), cert. denied, 475 U.S. 1057 (1986). Thus, the court carefully distinguished noted Lubrizol's duties to provide written quarterly sales reports and to make the data available to an independent auditor. The court found that Lubrizol's promise went beyond a “mere debt, or promise to pay money”, and was found to be executory. Lubrizol Enter., 756 F.2d at 1045-46.

\textsuperscript{91} 625 F.2d 290 (9th Cir. 1980).

\textsuperscript{92} Id. at 292.

\textsuperscript{93} Id.
in light of the court's finding that failure to perform this obligation would constitute a material breach.\textsuperscript{94} Although commonly applied, the Countryman test has not escaped criticism. A central objection is related to the need to address the policy considerations inherent in a decision as to whether a contract is executory. A rigid adherence to the Countryman test obscures these considerations. In discussing this issue, the Sixth Circuit noted that definitions such as the Countryman test are helpful, but do not resolve this problem. The key, it seems, to deciphering the meaning of the executory contract rejection provisions, is to work backward, proceeding from an examination of the purposes rejection is expected to accomplish. If those objectives have already been accomplished, or if they can't be accomplished through rejection, then the contract is not executory within the meaning of the Bankruptcy Act.\textsuperscript{95} This position can be criticized due to the open-ended nature of its inquiry.\textsuperscript{96} Judge Mabey, a proponent of this approach, counters by emphasizing that executory contracts are not characterized by "a mutuality of commitments, but by the nature of the parties and the goals of reorganization."\textsuperscript{97} The role of rejection in enlarging the value of the estate and furthering the creditor become the focus of the judicial inquiry.\textsuperscript{98} A second area of significant controversy is the circumstances in which a court will approve the rejection of a contract which has been found to be executory. This problem is generally attacked using one of two approaches. The first approach considers whether rejection is in the best interest of the estate as viewed in the business judgment of the trustee. The second approach proceeds by balancing the effects of rejection on both the debtor's estate and the contracting party. This area of controversy is, in the final analysis, the issue that led to the passage of the Intellectual Property Bankruptcy Protection Act.

Under the Bankruptcy Act of 1898, rejection of an executory contract was denied unless the contract was shown to be "onerous" or "burden-

\textsuperscript{94} Id. The licensee's argument that the contract was no longer executory because it had paid an initial $140,000 for the license rights was rejected by the court. In an analysis paralleling that of the Lubrizol court, the court emphasized the ongoing duty of the licensee to pay a royalty fee based on a percentage of the net return from the use of the licensed software.

\textsuperscript{95} In re Jolly, 574 F.2d 349, 351 (6th Cir. 1978).

\textsuperscript{96} This criticism was noted, but dismissed, in In re Waldron, 36 Bankr. 633, 639 (S.D. Fla. 1984). The court noted that although the approach could be criticized for being result oriented, result orientation is endemic to the policy choices which must be made in determining whether a contract is executory and rejectable under § 365. The court went on to state that the Countryman test is equally result oriented.

\textsuperscript{97} In re Booth, 19 Bankr. 53, 56 (D. Utah 1982).

\textsuperscript{98} See, e.g., In re Booth, 19 Bankr. 53, 58-61 (D. Utah 1982). In In re Oxford Royal Mushroom Products, 45 Bankr. 792 (Bankr. E.D. Pa. 1985) the court held that an executory contract is one where there remained substantial performance by either party to the agreement.
The concept of rejection of executory contracts had its roots in the principle that the trustee might abandon burdensome property. From this has grown one view that for the trustee to reject an executory contract, the contract must in fact be burdensome, i.e., involve some loss or detriment to the estate. What, however, of the situation where the contract, while profitable or generally beneficial, could be, if rejected, replaced by a more attractive arrangement? Since a primary purpose of the power to reject is to enlarge the estate of the debtor, there is little difference between a contract which consumes resources and is therefore burdensome and one which does not reflect the full value of an asset. In each case, the value of the estate is depressed, and the creditors receive a reduced payment. A related concern is that the burdensome test could “work a substantial injustice in cases where it can be shown that the non-debtor contracting party will reap substantial benefits under the contract while the debtor’s creditors are forced to make substantial compromises of their claims.”

The onerous and burdensome test has been supplanted by the “business judgment test”, which focuses instead on the judgment of the trustee that the rejection of the contract will benefit the estate. The leading case in this area is *Group of Institutional Investors v. Chicago, Milwaukee, St. Paul Pacific Railway Co.*, where the Supreme Court first articulated the business judgment standard. The business judgment standard has been followed by a number of recent cases, although there is considerable uncertainty as to whether the harm to the other contracting party should be considered as part of the court’s rejection decision.

Several recent cases have considered the rejection decision in light of the trustee’s business judgment and then proceeded to consider the impact of rejection on the other contracting party. The primary focus, however, has been the impact of rejection on general unsecured creditors. The interests of the other contracting party receive significantly less consideration.

For example, in *In re Huang*, the court considered a fact situation in which the debtor wished to reject an executory contract for the sale of real property. The court stated that “[t]he primary issue is whether the

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100 2 COLLIER ON BANKRUPTCY (15th ed.), Para 365.03 (356-18).


102 In re Minges, 602 F.2d 38, 43, (2d Cir. 1979).


104 318 U.S. 523 (1943).

105 23 Bankr. 798 (Bankr. 9th Cir. 1982).
rejection would benefit the general unsecured creditors."\textsuperscript{106} The court continued:

\begin{quote}
[I]t is proper for the court to refuse to authorize rejection of a lease or executory contract where the party whose contract is to be rejected would be damaged disproportionately to any benefit to be derived by the general creditors of the estate, as for example where most of the "benefit" of rejection of the contract would be captured by a third party at the expense of the unsecured creditors. This statement does not sanction rejection of a contract because of a generalized concern that a party whose contract is rejected will be damaged.\textsuperscript{107}
\end{quote}

This approach, although it considers the rights of the other contracting party, places much greater emphasis on the fact that the benefits of rejection will escape the creditors of the estate. The losses which accrued to the other contracting party in \textit{Huang} were limited to the anticipated profit from the appreciation of the real property in question.\textsuperscript{108} The court characterized these losses as merely the "disappointment of legitimate expectations" and allowed rejection of the contract.\textsuperscript{109}

A similar approach was used in \textit{In re Petur U.S.A. Instrument Co.},\textsuperscript{110} where the court considered the rejection of an executory contract which granted an exclusive license to build and sell the inventions of the debtor.\textsuperscript{111} The licensee's business was based solely on the distribution of the debtor's product and had been operating at a substantial profit. The \textit{Petur} court, while citing the \textit{Huang} decision with approval, distinguished the fact pattern before it by stating that the rejection of the license agreement would result in the destruction of the licensee's business.\textsuperscript{112} The court found that the harm to the licensee was more than the mere disappointment of legitimate expectations and characterized the consequences of rejection as the "ruination of an otherwise profitable, successful and ongoing business."\textsuperscript{113}

\textsuperscript{106} \textit{Id.} at 801.

\textsuperscript{107} \textit{Id.}

\textsuperscript{108} \textit{Id.}

\textsuperscript{109} \textit{In re Huang}, 23 Bankr. 798, 801 (Bankr. 9th Cir. 1982).

\textsuperscript{110} 35 Bankr. 561 (Bankr. W.D. Wash. 1983).

\textsuperscript{111} It is interesting to note the treatment given to the business judgment of the trustee. The court purported to accept the judgment of the debtor that its best interests and the best interests of the creditors would be served by rejection based on the debtor's belief that that the licensing arrangement prevented the debtor from fully realizing the profits available from the Canadian market. Later in the opinion, however, the court disputes this finding in stating that the "profits that the debtor envisions are only projections based on little, if any experience in the Canadian market" and that the licensee had "been effective in retailing in the Canadian market." The court concluded that the evidence did not show that the licensee would be unlikely to continue this performance or that the debtor would be able to do better. \textit{Id.} at 564.

\textsuperscript{112} \textit{Id.} at 563.

\textsuperscript{113} \textit{Id.} at 564.
As we have seen, *Huang*\(^{114}\), *Petur*\(^{115}\), and similar cases\(^{116}\) have applied the business judgment test and have indicated at least some willingness to consider the concerns of the party faced with rejection of the contract in cases where substantial harm to that party's business is likely to result. A second line of cases, while accepting the business judgment test, has declined to consider the impact of rejection on the licensee. It is this line of cases which generated intense concern in the intellectual property licensing community and substantial support from the business community for the amendment of 11 U.S.C. § 365.\(^{117}\)

The decision in *Lubrizol Enterprises v. Richmond Metal Finishers*\(^{118}\) became the focal point of these concerns. As noted previously, *Lubrizol* concerned a debtor's successful attempt to reject an agreement which granted Lubrizol a non-exclusive license to use a patent owned by the debtor.\(^{119}\) The Fourth Circuit Court of Appeals overturned a lower court ruling\(^ {120}\) which stated that rejection of the agreement would not deprive Lubrizol of the intellectual property rights acquired under the agreement.\(^ {121}\) As interpreted by the Fourth Circuit in *Lubrizol*, 11 U.S.C. § 365 entitled Lubrizol 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" although specific performance would normally be an available option upon breach of this type of contract.\(^ {122}\) Thus, Lubrizol was stripped of its rights to the licensed technology. The court noted the policy considerations inherent in its decision, but held that its decision was required under 11 U.S.C. § 365 even though the decision would impose serious burdens on contracting parties such as Lubrizol:

> [R]ejection in this and comparable cases could have a general chilling effect upon the willingness of such parties to contract at all with businesses in possible financial difficulty. But under bankruptcy law such equitable considerations may not be indulged by courts in respect of the type of contract here in issue.

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\(^{114}\) 23 Bankr. 798 (Bankr. 9th Cir. 1982).


\(^{116}\) E.g. Matter of Smith Jones, Inc., 26 Bankr. 289 (D. Minn. 1982), where the court explicitly conducted a "balancing of the relative benefits and detriments both to the debtor and to the other affected party" after determining that the debtor's continuing obligations were both "burdensome" and that requesting rejection was a "proper exercise of business judgment." *Id.* at 293.4.


\(^{118}\) 756 F.2d 1043 (4th Cir. 1985), cert. denied, 475 U.S. 1057 (1986).

\(^{119}\) *See supra* notes 88-90 and accompanying text.

\(^{120}\) *In re* Richmond Metal Finishers, 38 Bankr. 341 (E.D. Va. 1984).

\(^{121}\) *Id.* at 344.

\(^{122}\) Lubrizol Enter., Inc. v. Richmond Metal Finishers, 756 F.2d 1043, 1048 (4th Cir. 1985), cert. denied, 475 U.S. 1057 (1986). The court read 11 U.S.C. § 365(g) to provide a damages only remedy for the non-bankrupt party. At the same time, the court held that allowing specific performance would undercut the purpose of rejection under § 11 U.S.C. 365(a). *Id.*
Congress has plainly provided for the rejection of executory contracts, notwithstanding the obvious adverse consequences for contracting parties thereby made inevitable.\textsuperscript{123}

A similar analysis resulted in a similar outcome in \textit{In re Chipwich},\textsuperscript{124} where the debtor was allowed to reject executory contracts granting licenses to produce and sell dairy products under the debtor’s trademark.\textsuperscript{125} Since the rejection of the executory contracts would be advantageous to the debtor, the court allowed rejection while noting that rejection would deprive the licensee of its right to use the debtor’s trademark.\textsuperscript{126} The court, citing \textit{Lubrizol} and noting the likely chilling effect of its decision, also contrasted the factual situation before it from that in \textit{Petur} by stating that the damage to the licensee was not disproportionate to the benefit of the creditors in light of the fact that the license was not the foundation of the licensee’s business.\textsuperscript{127}

V. THE IMPACT OF THE INTELLECTUAL PROPERTY BANKRUPTCY PROTECTION ACT ON INTELLECTUAL PROPERTY LICENSE AGREEMENTS

The Intellectual Property Bankruptcy Protection Act was enacted largely in response to concerns raised by the \textit{Lubrizol} decision and its progeny. As discussed previously, the primary purpose of the Act is to promote intellectual property licensing by providing certainty as to the licensee’s right to the continued use of the licensed property in the event of the licensor’s bankruptcy.\textsuperscript{128} The Act pursues this objective by allowing the licensee to elect to retain its rights to the licensed property as they existed at the commencement of the bankruptcy action.

The agreement in \textit{Lubrizol Enterprises v. Richmond Metal Finishers}\textsuperscript{129} typifies a straightforward license agreement which is within the intended reach of the Act. The agreement provided that Lubrizol would receive a non-exclusive license to utilize a patented metal coating process developed by Richmond Metal Finishers [Richmond] in return for royalty payments.\textsuperscript{130} The agreement contained other provisions which imposed ongoing obligations on both parties. Lubrizol was required to account for and pay royalties for use of the process. Richmond was required to notify Lubrizol of any patent infringement suit and to defend in any such suit, to extend to Lubrizol most favored licensee status, and to indemnify Lubrizol for losses arising out of any misrepresentation or breach of warranty.\textsuperscript{131} The contract also provided that Lubrizol was not to utilize the

\textsuperscript{123} Id.
\textsuperscript{124} 54 Bankr. 427 (Bankr. S.D.N.Y. 1985).
\textsuperscript{125} Id. at 428.
\textsuperscript{126} Id. at 431.
\textsuperscript{127} Id. at 431.
\textsuperscript{128} See supra notes 7, 8 and accompanying text.
\textsuperscript{129} 756 F.2d 1043 (4th Cir. 1985), cert. denied, 475 U.S. 1057 (1986).
\textsuperscript{130} See supra notes 86-90 and accompanying text.
\textsuperscript{131} Id.
licensed technology for a period of nine months after the agreement was signed.\(^{132}\)

Under the Act, rejection by Richmond would leave Lubrizol with two options. First, Lubrizol could treat the rejection as terminating the contract under 11 U.S.C § 365(n)(1)(A). By accepting rejection, Lubrizol would be stripped of its rights to the licensed process as embodied in the rejected agreement. Richmond would be relieved of its ongoing duties under the agreement, and would be free to negotiate other agreements concerning the underlying technology unencumbered by the agreement with Lubrizol.\(^{133}\) Lubrizol's second option would be to elect under 11 U.S.C. § 365(n)(1)(B) to retain its rights to the intellectual property as they existed immediately prior to the commencement of Richmond's bankruptcy case. Lubrizol could then continue to utilize the licensed technology for the duration of the agreement and for any period for which it could extend the license as of right.\(^{134}\) In addition, Lubrizol would be required to make all royalty payments due under the contract for the duration of the contract or any extensions as of right.\(^{135}\) The Act would also require that Lubrizol waive its rights to setoff of damages and any claims for allowance of administrative expenses, although Lubrizol would still retain a general claim for damages as a breach of contract under 11 U.S.C. § 365(g).\(^{136}\) Although Lubrizol would be unable to seek specific performance of other contractual obligations under the agreement, Richmond or its trustee would be required to allow Lubrizol to exercise its rights to the licensed technology and to provide it with the intellectual property and any embodiments to which it was entitled under the agreement.\(^{137}\) Hence, Lubrizol would not be entitled to seek specific performance of Richmond's duty to defend patent infringement suits.

The Act is successful, when considered in the context of the *Lubrizol* decision, in addressing the negative aspects of rejection while addressing the needs of the bankrupt's estate. Of foremost importance is the fact the contracting party has an option to retain the bargained for technology. This option addresses the root of the concerns, which surfaced after *Lubrizol*, that rejection by the licensor would deprive the licensee of an essential component of its product or process.\(^{138}\) Under the Act, the licensee who has based at least some portion of its business on an intellectual property license is protected from the immediate loss of that license. The licensee therefore has a breathing space equal to the duration of the agreement in which to find a substitute for the intellectual property covered by the license.


\(^{133}\) This provision is the statutory equivalent of the judicial decision in the *Lubrizol* case.


\(^{138}\) *See generally* *Hearings*, *supra* note 68; J. McLAUGHLIN, *supra* note 38.
Although the Act provides significant protection to the licensee, limitations on the duties of the bankrupt under rejection, which function to protect the bankrupt and its estate by shielding the bankrupt from specific performance, are retained. One obligation common to intellectual property licenses is the licensor's duty to defend patent infringement suits.\textsuperscript{139} Although rejection would excuse the licensor from defending an infringement suit, the licensee could enter a general, unsecured claim against the estate for the cost of its defense in the suit under 11 U.S.C. § 502(g). The licensee would also lose the benefit of royalty reductions based on most favored licensee status, although an unsecured claim for damages is not precluded.\textsuperscript{140} Thus, as applied to a straightforward patent license such as the one encountered in \textit{Lubrizol}, the Act achieves its objective. It provides the licensee with continued access to the licensed technology while relieving the debtor of the duty of ongoing performance.

A somewhat different scenario is presented by the facts of \textit{In re Petur U.S.A. Instrument, Co.}\textsuperscript{141} The debtor-licensor, Petur U.S.A. Instrument, had invented a line of scientific instruments and had received patent protection for its inventions.\textsuperscript{142} The non-debtor party, Petur of Canada, was a company formed solely for the purpose of marketing the debtor's products.\textsuperscript{143} The parties entered into a twenty year license agreement which provided Petur of Canada with the exclusive right to use, manufacture, assemble, and sell the inventions and related components in Canada.\textsuperscript{144} Petur U.S.A. agreed to provide the necessary expertise and know-how and also agreed to perform sixteen hours per month of consulting services. In return, Petur of Canada paid a fixed fee and agreed to pay royalties based on a percentage of gross sales.\textsuperscript{145}

Recall that the \textit{Petur} court denied the debtor's motion to reject the agreement because rejection would result in the destruction of the non-debtor's business.\textsuperscript{146} In addition to retaining its rights to manufacture, assemble, and sell the licensed inventions, Petur of Canada also retained its right to the licensor's know-how and the bargained for consulting services. The court's refusal to allow rejection afforded the licensee with the maximum protection it could receive under the agreement—the license agreement remained in effect, and both parties continued to be

\textsuperscript{139} The expense of defending these suits can often be significant. Fees for attorneys and expert witnesses, in addition to court costs, can be expected to total between $250,000 and $1.5 million. The expense of such a suit could consume the debtor's entire estate. T. Hemnes, \textit{supra} note 54, at 4.

\textsuperscript{140} This situation applies only to non-exclusive license agreements. Recall that 11 U.S.C. § 365(n)(1)(B) specifically allows a licensee to "enforce any exclusivity provisions" if the licensor elects to retain its rights under the license.

\textsuperscript{141} 35 Bankr. 561 (W.D. Wash. 1983).

\textsuperscript{142} \textit{Id.} at 561-62.

\textsuperscript{143} \textit{Id.} at 562.

\textsuperscript{144} \textit{Id.}.

\textsuperscript{145} \textit{Id.}.

\textsuperscript{146} See \textit{supra} notes 110-113 and accompanying text. The court implicitly rejected the \textit{Lubrizol} court's view that the effect of the rejection should not be considered due to the explicit statutory language embodied in 11 U.S.C. § 365 prior to passage of the Act.
bound by its terms. At the same time, the estate of the bankrupt received minimal protection. The bankrupt was unable to reject the executory license agreement and was thus prevented from obtaining the benefit of more favorable license terms which, in its business judgment, could be obtained if it were free to negotiate with other potential licensees. At the same time, the licensor was required to continue providing consulting services under the agreement.

If the Intellectual Property Bankruptcy Protection Act had been in effect at the time of the Petur decision, the rights and obligations of the parties would have been significantly altered. As we have seen, the Act allows the bankrupt party to reject the contract subject to the licensee's right to retain its rights to the licensed technology.\(^{147}\) In the Petur case, where the contract was found to be executory and where rejection was arguably within the sound business judgment of the trustee, rejection would be permitted under the Act. Assuming that Petur of Canada would elect to retain its rights as provided by the Act,\(^{148}\) it would be entitled to the rights to the intellectual property as they existed immediately prior to the commencement of the debtor's bankruptcy case. Petur of Canada would thus retain its exclusive right to use, manufacture, assemble, and sell the invention in Canada. Rejection by Petur U.S.A. would then prevent Petur of Canada from seeking specific performance of the obligations remaining under the agreement. Most significantly, the Petur of Canada (the licensee) would be unable to obtain specific performance of the licensor's consulting services.\(^{150}\) These services are largely inseparable from the technology which is the subject of the license agreement, and are important even as applied to the technology as it existed at the time the parties entered into the agreement.\(^{151}\) They are easily distinguished from

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\(^{147}\) 11 U.S.C. § 365(n) (1988). The Act would seem to prevent the court from denying a debtor's motion to reject in cases where the court is concerned that rejection could result in a disproportionate damage to the non-debtor party. Although a debtor's motion to reject remains subject to the court's approval under 11 U.S.C. § 365(a), the Act is based on an explicit Congressional consideration of the policy objectives underlying the rejection of intellectual property license agreements. In light of this Congressional assessment, the provisions of the Act are intended to provide the proper degree of protection to parties involved.


\(^{149}\) The Senate states that the licensee under the rejected license “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.” S. Rep. No. 505, supra note 8, at 9.

\(^{150}\) This result is consistent with the congressional intent: The debtor/trustee will essentially have no obligation to the licensee after rejection other than to turn over existing technology and permit the licensee to use the technology. Obligations such as that to provide the licensee with continued training in the use of the technology or with updates of the technology will be terminated. H. R. Rep. No. 1012, supra note 7, at 7.

\(^{151}\) The bargained for consulting services are extremely important because the inventor is in a superior position to facilitate the manufacture, application, and installation of the invention. It is not uncommon, for example, to encounter unanticipated difficulties in the manufacture of a product. The inventor, with his superior knowledge of the principles which govern the operation of the invention, is more likely to successfully pinpoint the cause of these difficulties and to identify suitable corrective action. The inventor is also in a superior position with regard
the obligation to defend patent infringement actions and the obligation to modify royalty rates based on subsequent license agreements. When viewed from a business perspective, these obligations, as contrasted to the inventor's ongoing consulting duties, do not relate directly to the application of the licensed intellectual property, and are at worst speculative.

Without the expertise of the inventor, the licensee's ability to commercialize the invention successfully could be significantly impaired because the inventor, with his intimate knowledge of the licensed technology, is in a much better position to recognize and correct for unforeseen difficulties encountered in its application. The fact that the parties included consulting services in the license agreement supports the view that the parties recognized the inventor's superior position.

At the same time, Petur would be required to "make all royalty payments due" under the contract. The Act provides that the licensee, in electing to retain the licensed technology, waives "any right of setoff it may have" under the contract as well as administrative claims otherwise allowable under 11 U.S.C. § 503(b). Thus, Petur of Canada would be unable to subtract from the royalty payments for damages resulting from Petur U.S.A.'s non-performance of its consulting obligations. It could, however, assert a claim against the estate for damages caused by the rejection as a breach of contract under § 365(g) of the Bankruptcy Code. This would allow Petur of Canada to present a claim for the damages to solving problems related to the application of the product under varying conditions and for unusual or unanticipated purposes. Hence, consulting services can be an extremely important component of an intellectual property license agreement.

The inventor's consulting duties assume a much greater role where the parties contemplate that the license technology may require modification as part of the commercialization process. In this situation, the inventor's expertise becomes even more important because familiarity with the underlying technological principles is prerequisite to the successful implementation of modification. This expertise is often not easily acquired. Recall that this lack of expertise is a factor which tends to make licensing an attractive option in the first place. See supra notes 33-78 and accompanying text; See also G. Freedman, supra note 64, at 316.

11 U.S.C. § 365(n)(2)(B) (1988). Performance due by the licensee can extend beyond royalty payments, especially in cases where some or all of the consideration is provided by the licensee in the form of related licenses extended to the debtor. A licensee who elects to retain its technology rights under a rejected contract is bound by his other obligations or duties under the contract, "except for those so directly related to obligations or duties that the licensor has been freed from by rejection as to make it inequitable to bind the licensee to them." H. R. Rep. No. 1012, supra note 7, at 7.

Id. The purpose of this provision is to insure that the debtor-licensor will continue to receive the income from royalty payments which is often essential to the debtor's reorganization. G. Hahn, Testimony Before the Subcommittee on Courts and Administrative Practice of the Senate Judiciary Committee on S. 1626, at 8 (June 10, 1988). In contrast, the right to setoff is explicitly allowed in cases involving the rejection of unexpired leases of real property as well as executory contracts for the sale of real property. 11 U.S.C. 365(h) and (i) (1988).

resulting from the licensor's non-performance.\textsuperscript{155}

The \textit{Petur} fact pattern presents a situation which is somewhat more complex than the fact pattern in the \textit{Lubrizol} case. In \textit{Lubrizol}, the technology was transferred as it existed under the licensor's patent. The licensor was not obligated to perform further duties related to the transfer of the technology itself. Under the agreement, \textit{Lubrizol}, the licensee, assumed, at least under the contract, the totality of the efforts necessary to successfully utilize commercially the licensed technology as it existed at the time of the contract. The licensor in \textit{Petur}, on the other hand, was entitled under the agreement to receive the ongoing benefit of the inventor's expertise in the operation and application of the technology.

\textbf{VI. CONCLUSION}

The licensing of intellectual property is an important means of facilitating the commercialization of technology in a cost effective manner. Recent court decisions which allowed a bankrupt licensor to reject the terms of an intellectual property license agreement and thereby strip the licensee of the rights which it had acquired under the rejected agreement acted as a general disincentive to enter into these license agreements. The Intellectual Property Bankruptcy Protection Act is intended to address these concerns. The central concern of the licensee, that it retain access to the licensed technology, has been addressed by the Act. At the same time, the interests of the debtor and its estate remain protected. The debtor continues to receive royalty income from the licensed technology, while it is also relieved of the burden of specific performance.

The Act also imposes costs on both parties. Perhaps most significantly, the licensee cannot obtain specific performance of the licensor's obligations related to training and support of the licensed technology, although it can seek at least partial compensation for these losses via a claim as a creditor of the estate. In contrast, the licensor is bound to the terms of the agreement and is precluded from depriving the licensor of access to the technology in order to enter into a subsequent, potentially more lucrative agreement. When viewed in this way, the Intellectual Property Bankruptcy Protection Act is largely successful in addressing the needs of both the licensee and the bankrupt licensor without undue disruption of the policies underlying the rejection of executory contracts.

\textit{JOHN J. FRY}

\textsuperscript{155} Note that this claim would be considered as a breach of contract occurring immediately before the date of the debtor's bankruptcy petition. \textit{Petur} of Canada would therefore be treated as a general unsecured creditor. \textit{See supra} notes 29-32 and accompanying text. Assuming that the estate is insufficient to cover its debts, the licensee would receive only some fraction of the actual damages.