INTELLECTUAL PROPERTY CONTRACTS IN BANKRUPTCY

HEARING

BEFORE THE

SUBCOMMITTEE ON MONOPOLIES AND COMMERCIAL LAW

OF THE

COMMITTEE ON THE JUDICIARY HOUSE OF REPRESENTATIVES

ONE HUNDREDTH CONGRESS

SECOND SESSION

ON

H.R. 4657

A BILL TO AMEND THE BANKRUPTCY LAWS WITH RESPECT TO REJECTION OF INTELLECTUAL PROPERTY LICENSES

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INTELLECTUAL PROPERTY CONTRACTS IN BANKRUPTCY

FRIDAY, JUNE 3, 1988

House of Representatives,
Subcommittee on Monopolies and Commercial Law,
Committee on the Judiciary,
Washington, DC.

The subcommittee met, pursuant to call, at 9:40 a.m., in room 2141, Rayburn House Office Building, Hon. Don Edwards, presiding.

Present: Representatives Edwards, Hughes, Smith of Florida, Staggers, Fish, Moorhead, Hyde, and Sensenbrenner.

Staff present: Gary Goldberger and Judith Bailey, counsel; Peter Levinson, associate counsel; Christine Abdallah, clerk.

Mr. Edwards. The subcommittee will come to order.

The Subcommittee on Monopolies and Commercial Law meets this morning to hear testimony on H.R. 4657, a bill concerning the rejection of intellectual property contracts in bankruptcy.

(A copy of H.R. 4657 follows:)

100TH CONGRESS
2D SESSION

H. R. 4657

To amend title 11 of the United States Code with respect to the rejection of executory contracts licensing rights to intellectual property.

IN THE HOUSE OF REPRESENTATIVES

MAY 23, 1988

Mr. EDWARDS of California introduced the following bill; which was referred to the Committee on the Judiciary

---

A BILL

To amend title 11 of the United States Code with respect to the rejection of executory contracts licensing rights to intellectual property.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. AMENDMENTS TO TITLE 11 OF THE UNITED STATES CODE.

(a) DEFINITION.—Section 101 of title 11, United States Code, is amended—

(1) in paragraph (50) by striking "and" at the end, and

(2) in paragraph (51) by striking the period at the end and inserting a semicolon, and

(3) by adding at the end the following:

"(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.".

(b) EXECUTORY CONTRACTS LICENSING RIGHTS TO INTELLECTUAL PROPERTY.—Section 365 of title 11, United States Code, is amended by adding at the end 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 (other than a right under applicable nonbankruptcy law to specific performance of such contract) under such contract, and 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 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; and

"(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.

"(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.".

SEC. 2. EFFECTIVE DATE; APPLICATION OF AMENDMENTS.

(a) EFFECTIVE DATE.—Except as provided in subsection (b), this Act and the amendments made by this Act shall take effect on the date of the enactment of this Act.

(b) APPLICATION OF AMENDMENTS.—The amendments made by this Act shall not apply with respect to any case commenced under title 11 of the United States Code before the date of the enactment of this Act.

Mr. EDWARDS. I introduced this bill last month because of my concerns about the need for the continued licensing of intellectual property rights and about the chill on the free flow of intellectual property which has been created under the bankruptcy code by recent court decisions.

Because of these decisions, there exists today an immediate and real threat to the continued development of the technology upon which our economy and our standard of living depends.

With us today is a distinguished group of witnesses who are experts in the fields of intellectual property and bankruptcy law. We very much appreciate their willingness to provide us with their views on H.R. 4657.

Without objection, I will insert my longer opening statement in the hearing record. I also ask unanimous consent to insert at this point the opening statement of Chairman Rodino, who is unavoidably detained in New Jersey today, but who is very interested in this bill.

[The statements of Hon. Peter W. Rodino, Jr. and Hon. Don Edwards follow:]

Opening Statement -- Peter W. Rodino, Jr.
Chairman, Subcommittee on Monopolies and Commercial Law
Hearing on H.R. 4657
June 3, 1988

The Subcommittee on Monopolies and Commercial Law meets today to consider H.R. 4657, legislation introduced by Mr. Edwards, the gentleman from California and a member of the Subcommittee, regarding the treatment of intellectual property licenses by the bankruptcy laws. Interest in this issue was in large measure sparked by the decision in the Lubrizol case, in which the U.S. Court of Appeals for the Fourth Circuit permitted a debtor to reject an executory license agreement involving intellectual property -- terminating the licensee's use of the technology -- without regard to the effect that rejection would have on the licensee or the estate. Industries that rely heavily on licensing arrangements -- particularly the high technology industry that is so vital to our nation's economy -- became concerned about the effect of a bankruptcy on these arrangements.

The legislation we consider today would permit a licensee to continue to use licensed technology even after a debtor rejects the license agreement. This hearing will explore the impact the Lubrizol decision has had on intellectual property transactions, whether special treatment of intellectual property license agreements in the bankruptcy laws is desirable, and, if so, in what form this treatment should be implemented. We must keep in mind throughout this process, of course, the goals of the bankruptcy laws of balancing the interests of debtors with the interests of creditors, and of facilitating successful reorganizations.

I commend Congressman Edwards for his efforts in bringing this issue to the Subcommittee's attention.

The witnesses who appear today are well qualified to address the interrelationship between the bankruptcy laws and intellectual property. The Subcommittee greatly appreciates their assistance.

STATEMENT OF THE HONORABLE DON EDWARDS
Subcommittee on Monopolies and Commercial Law
Committee on the Judiciary
Hearing on H.R. 4657, June 3, 1988

The Subcommittee on Monopolies and Commercial Law meets this morning to hear testimony on H.R. 4657, a bill concerning the rejection of intellectual property contracts in bankruptcy.

I introduced this bill last month because of my concerns about the need for continued licensing of intellectual property rights and about the chill on the free flow of intellectual property created under the bankruptcy code by recent court decisions.

As we all know from the new products and services that crop up in our daily lives, we are in the midst of a technological revolution. Over the past 40 years, the American economy has thrived on the development of new ideas and inventions. Frequently, this new technology makes its way into the marketplace through intellectual property licensing agreements, with the business, university, or individual entrepreneur who developed that intellectual property granting a license to someone else to use or market it. Entire businesses may be built upon the intellectual property licensed from other parties.

Recent decisions under the bankruptcy laws, however, put this system of icensing into jeopardy by threatening a licensee's continued use of intellectual property after the licensor files bankruptcy.

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Of particular concern is the decision in Lubrizol Enterprise, Inc. v. Richmond Metal Finishers, Inc. In that case, a lower federal court held that under section 365 of the Bankruptcy Code, the trustee of a bankrupt licensor could reject a license agreement and deny the licensee's continued use of the intellectual property. The Supreme Court refused to review that lower court's decision.

Thus, Lubrizol stands as a serious and immediate threat to the free flow of intellectual property in our economy. Companies are understandably fearful of entering into intellectual property licensing agreements if the financial difficulties of a licensor can cause the loss of a licensee's rights to that intellectual property.

H.R. 4657 is designed to reverse the impact of cases such as Lubrizol. It amends section 365 to permit a licensee of intellectual property to continue to use that property, even after a trustee rejects a license agreement. The bill allows the licensee to elect to retain the intellectual property rights it had under the license, as such rights existed immediately before the bankruptcy case commenced. Obviously, if such rights were exclusive rights, that exclusivity would be preserved by the licensee upon such election.

However, except as provided in the bill, the licensee does give up any right to specific performance. In addition, the licensee waives any right of offset it might have, waives certain claims under sec. 503(b) of the bankruptcy code, and must continue to make all payments due under the contract for the duration of the contract. The licensee does retain a general claim for damages from rejection as a breach of contract under sec. 365(g) of the bankruptcy code.

Intellectual property is inherently unique. Thus, H.R. 4657 affects only the status of executory contracts for licenses of intellectual property. It does not affect the status in bankruptcy of other types of executory contracts.

With us today is a distinguished group of witnesses who are experts in the fields of intellectual property and bankruptcy law. We very much appreciate their willingness to provide us with their views on this legislation.

Mr. EDWARDS. I now yield to the gentleman from West Virginia, Mr. Staggers.

Mr. STAGGERS. I have no statement, Mr. Chairman.

Mr. EDWARDS. Very good.

We have four witnesses today to help us explore the issues of the rejection of executory intellectual property licenses in bankruptcy. They are 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 and Hessen, testifying on behalf of the National Bankruptcy Conference; and Thomas M.S. Hemnes, Esq., of Foley, Hoag & Eliot.

Gentlemen, will all of you please come to the witness table and give your oral testimony in the order in which I mentioned your names. If you don't mind, we will operate as a panel. We have both proponents and an opposition witness here today, so we're going to be very interested in the case that is being made for and against this bill. I believe that we will hold our questions until you have all finished giving your oral presentations.

I welcome the gentleman from California, Mr. Moorhead. Do you have a statement, Mr. Moorhead?

Mr. MOORHEAD. I do not.

Mr. EDWARDS. Very good.

Mr. Burger, representing Apple Computer, Inc., and the Computer and Business Equipment Manufacturers Association, will testify first. Please try to keep your testimony somewhere around five or six minutes. We will have a light in front there to give you a little hint, although we'll be generous with the time. Without objection, all of the statements which are in more detail will be made a part of the record.

We also welcome the gentleman from New York, the ranking minority member, Mr. Fish. Mr. Fish, do you have a statement?

Mr. FISH. No, I don't, Mr. Chairman. Thank you.

Mr. EDWARDS. Very good.

Mr. Burger.

TESTIMONY OF JAMES M. BURGER, CHIEF COUNSEL, GOVERNMENT, APPLE COMPUTER, INC., APPEARING ON BEHALF OF THE COMPUTER AND BUSINESS EQUIPMENT MANUFACTURERS ASSOCIATION AND THE BANKRUPT LICENSORS COALITION; ACCOMPANIED BY MARILYN SHEA-STONUM, ESQ., JONES, DAY, REAVIS & POGUE, CLEVELAND, OH; THOMAS M.S. HEMNES, ESQ., FOLEY, HOAG & ELIOT, BOSTON, MA; GEORGE A. HAHN, ESQ., HAHN & HESSEN, APPEARING ON BEHALF OF THE NATIONAL BANKRUPTCY CONFERENCE; AND HARRY F. MANBECK, ESQ., GENERAL ELECTRIC COMPANY, APPEARING ON BEHALF OF INTELLECTUAL PROPERTY OWNERS, INC.

Mr. BURGER. Thank you, Congressman.

Good morning, Congressmen and staff. My name is James M. Burger and I am Chief Counsel, Government, for Apple Computer. I am representing the Bankrupt Licensors Coalition. We are an organization of companies and associations from seven industries that are dependent on licenses for our business. We are one of those companies, and our industry computer coalition is CBEMA, the Computer Business Equipment Manufacturers Association.

With me here today, to my left, is our counsel, Marilyn Shea-Stonum from Jones, Day, Reavis & Pogue.

What I thought I would do this morning is briefly explain, from Apple Computer's perspective, why we are concerned about the *Lubrizol* case and why we welcome this legislation.

Intellectual property licenses form the heart of the microcomputer industry. One of the problems in our business is determining from the very start the value, particularly in the copyright area, of a computer program. It is often very speculative. Thus, it is extremely hard to have a transfer of the property, to have a purchase of the property, because we don't know whether the program is going to be successful or not. Very often, as I will explain a little bit later, these programs are created by an individual or a couple of individuals, rather than a large corporation, who invest a lot of their time in creating this piece of intellectual property.

The concern at the bargaining point, at the very beginning, is that the buyer doesn't want to pay too much for something he doesn't know what it's worth, and the seller doesn't want to receive too little for something they have invested a lot of time in. So it is difficult to establish a price at the beginning. Thus, the industry has found, virtually from its inception, that licensing is the best method to eliminate guessing at the beginning of a relationship what the value of that intellectual property will be.

Lubrizol, on the other hand, has posed a threat to us. We feel that long-term licenses are beneficial to both sides, and *Lubrizol* has said we're going to throw that whole relationship in doubt, that that relationship can be terminated by the bankruptcy court.

A licensee could have major dollars riding on this small piece of the whole situation, which would be the license. Many computer companies have their entire computer based around licensed technology. In our case this isn't quite as true, but most of the clone manufacturers, personal computer manufacturers, license the heart of their computer from a small company called Phoenix Technologies. If that company were to go bankrupt, tens of American computer companies would have their machines thrown into doubt, whether they could continue to market them, until a bankruptcy court resolved it.

In our case, we have a number of software programs which we have spent millions of dollars in integrating into our systems and to promoting, which have become very successful and resulted in a lot of money for the authors, to whom we wouldn't have paid a lot of money up-front because we weren't quite sure that their product would necessarily sell well.

Thus, I think the problem of *Lubrizol* is that it threatens America's lead in technology. One of the things that I think our country is great at is the individual entrepreneur creating brilliant software programs, at least in our industry; and, in other industries creating inventions and patents that far outstrip the ability of other countries to create intellectual property. There are a number of other countries which are good at looking at hardware and creating hardware cheaper, perhaps, than we can. But I think there are very few countries that have the intellectual capital that this country has.

We found at Apple Computer, not just at our beginnings, but looking at many other people in the microcomputer industry, that great ideas often come from an individual or a small group of individuals who take the risk, who take a couple of years of their life and sit in a basement some place programming away and come up with a brilliant idea. Under today's licensing system, these people have an incentive to spend a year, two or three years without earning a single dime because they know they can go to a larger company, an Apple, an IBM or some other computer company, with a piece of intellectual property they have invested their lives in. They don't need to negotiate away the entire value. They don't have to convince a large company they have got to invest a lot of money to buy the program. They can strike a deal that will let the marketplace determine the value of the program. I think we need to stimulate those competitive geniuses, those creative geniuses.

The copyright and other intellectual property laws were designed from the very beginning of this Republic to both protect intellectual property and stimulate the creative geniuses. I think we need to bring the bankruptcy laws back into synch with those traditional intellectual property laws.

I want to personally thank Congressman Edwards for introducing this bill. Our coalition believes that H.R. 4657 will strike the appropriate balance between the needs of the bankrupt and those of the creators and employers of intellectual property. Thank you very much.

[The statement of James M. Burger follows:]

TESTIMONY OF

JAMES BURGER
APPLE COMPUTER, INC.

Before The

SUBCOMMITTEE ON MONOPOLIES AND COMMERCIAL LAW

COMMITTEE ON THE JUDICIARY

UNITED STATES HOUSE OF REPRESENTATIVES

June 3, 1988

I am James Burger, Chief Counsel – Government of Apple Computer, Inc. I am here today in strong support of H.R. 4657, the "Intellecutal Property and Bankruptcy Bill."

I bring with me not just the support of my corporation, but also support from all of the members of the Bankrupt Licensor Coalition, an organization of corporations and associations from several industries that depend on licenses to conduct substantial amounts of their business. (List attached.) These organizations have been concerned for several years about the growing implications of the **Lubrizol** case. That concern grew markedly when the Supreme Court refused to review the decision.

I will focus my statement on the implications of the Lubrizol case for the information technology industry, which represents almost 6% of the U.S. gross national product. But while my examples come from one industry, the unfortunate situation that confronts us regarding licenses during bankruptcy proceedings affects all license users in similar ways.

My industry has developed an impressive profile since our birth just 45 years ago, in the middle of World War II. In less than half a century, computers, copiers and other high technology inventions have revolutionized the way America lives, the way America does business. We have produced the Information Age, an age in which individuals have, sitting on their desktops and on their kitchen tables, power our grandparents did not even dream of. At the click of a few keys on a keyboard, Americans today have the ability to find answers to questions, analyze information and create the new ideas that are keeping our society and our economy thriving.

Today's revolutionary information technology rests on the solid foundation of the U.S. legal system. Our companies have developed their products by relying firmly on the incentives and protections our legal system has long offered to people and companies with creative ideas. We have relied on intellectual property incentives and protections —copyrights, patents, trade secrets, and most clearly licenses— to stimulate the creation and to protect the value of the revolutionary American hardware and software. Through intellectual property protection, our companies have been able to realize the monetary value of their creations and build on them a thriving industry that today employs well over a million people.

At issue today is one of those protections: the license. Licensing is key to the way our industry functions. One person or one company —even a company as creative as Apple— cannot possibly come up with all the best ideas on how to improve products and create new ones. In fact, we've found that sometimes individuals or small groups working alone at night in their garages or living rooms come up with some of the best ones.

It's not every person who can follow Steve Jobs and Steve Wozniak and create an entire company based on those ideas. Instead, it's often to the benefit of everyone —inventor, company and consumer— for the inventor to license the idea to a company that's already established.

Why license rather than sell? There are several reasons:

- First, it's often difficult to establish the exact value of an idea or an invention before it goes into the marketplace. You'll remember that several years ago we introduced the Lisa computer— a computer full of great ideas. Unfortunately, the Lisa was not a market success, despite its great ideas. In contrast, our Macintosh is a fantastic success. It is now keeping over a million customers happy and eager for more.

  All those licenses represented great ideas, but we couldn't determine their real worth until we saw how the products fared in the marketplace.

- Second is a related issue: sharing the risk. Through licenses, we can incorporate ideas into a product and share the financial risk with the ideas' creators. If the ideas work, everyone benefits. If they don't, the company absorbs the direct loss in manufacturing costs; but, it doesn't have to pay a high price for an invention that went nowhere. It's similar to risk–sharing in other industries, such as publishing: the professor whose textbook doesn't sell doesn't get royalties; while the author of a best-seller makes a bundle.

- Third, we get the best ideas through licensing. Today's inventors are savvy. They understand the value of their ideas. They don't want to sell them outright; they want to make sure they share in the total financial rewards of their ideas. Licensing allows them to benefit, and it allows us to bring those ideas to our customers.

Let me give you an example: HyperCard. Many of you are probably familiar with this revolutionary product that allows enormous flexibility in arranging and accessing data. HyperCard is not a traditional software application, like a word processing, spreadsheet, or database program. It is rather, a software engine – a information tool kit, if you will. It delivers information in forms that go beyond traditional list and database report methods.

HyperCard is sweeping the education community. Researchers are using it to organize data. Teachers are using it to create innovative teaching tools.

Let me give you an example. Through HyperCard, today's students studying geography can actually point to a spinning globe on their computer screen and click on Washington and see an aerial view of the city stored on a compact disk memory device. Then. the student can zoom into the Lincoln Memorial and watch a film clip of Ramond Massey reading the Gettysburg Address. With HyperCard, educators are revolutionizing the education experience, and this is only one example of the many diverse uses of HyperCard that non-programmers are accomplishing.

HyperCard is not an Apple creation. It is a licensed product. Bill Atkinson authored HyperCard and persuaded us of its value in 1985. Everyone knew it was a great idea. But would it sell? Could we persuade people to use it.

If Apple had had to buy the HyperCard technology, we probably would have done so. But because of the risk, we would not have paid a very high price. Licensing, however, allowed us to share the risk with Atkinson. And as a result, he has been very handsomely rewarded.

This scenario has been repeated hundreds of thousands of times in our industry. Apple, for instance, is currently the licensee for a number ideas and products, Consumer happiness with our products and, consequently, our continued success rests on our access to those licensed items. And every other company in our industry is in exactly the same position: reliance on the license for some of its most successful products.

Thus our entire industry was shaken by the Supreme Court's decision last year not to intervene in the case of **Lubrizol v. Richmond Metal Finishers. They allowed to stand a lower court decision that seriously undermines the utility of the license as a business tool. In essence, that decision decided that the licenses of a bankrupt company or person can be rejected, that they can be declared void with very little notice, no matter what the damage is to the licensing company, no matter what the effect is on the customer.**

Let me tell you what the affects would be on licensing companies if this decision were allowed to stand.

- Inevitably, a licensor will go bankrupt,

- The licensee company would find itself without a key part of a product. For instance, they might lose the right to use a key chip.

- The production line for the personal computers would immediately shut down.

- It's possible that if they anticipated a long delay, the company would have to lay off the workers on that line. That's your constituents suddenly out of work.

- Then there's the financial impact on the company. Suddenly, they're not selling any top of the line personal computers. They're faced with a massive financial problem that they might have to deal with through still more layoffs.

- Then comes the ripple effect. Dealers don't have any personal computers to sell. Revenues plummet. Depending on how fast the company can solve the problem, some dealers could well go bankrupt themselves.

- And then there are customers--again, your constituents. Expansion plans are wiped out. For business customers, that could mean a slow-down in their productivity. Even worse, they may not be able to get a key piece of equipment repaired because they can't get a new spare part.

- In the meantime, the company is scrambling around trying to find a substitute for key chip. They'd probably be able to do it. But at what cost? And at how much delay? The answer would come in the end-of-year financial report, and it wouldn't be pleasant.

If this sounds like the old children's verse about "for lack of a nail, the shoe was lost" and so on until the war is lost, you're right. Ths unexpected loss of a license for a key product —an eventuality that, under today's law, no company can protect against— can hit healthy companies with a lethal blow from which recovery could be difficult or even impossible. No company in our industry, no company that uses licensed technology in any way, is safe from this problem until you change the law.

Obviously, Apple could not continue to do business under these circumstances. We would have to discontinue our use of the licenses and to enter into negotiations to buy out all those licenses on which we now depend. If creators refused to sell their products outright, we would have to find substitutes for them. Everyone loses. Apple's costs would go up because we would have to search for substitutes. **And creators would lose their chance to reap the rewards of their best ideas.**

Clearly, no one intends this outcome. For years, our society has believed that, during bankruptcy proceedings, technology licenses were to be treated the same as real estate leases--that as, they were to be in effect until the expiration date in the license, and then subject to renegotiation. That's how licenses were treated until lawyers uncovered this loophole in the law.

I commend Mr. Edwards for recognizing the need for Congress to close this loophole. It is an outcome clearly unintended by the drafters of the Bankruptcy Act. Hundreds of thousands of companies, millions of workers depend today on licenses for their economic future. We need to ensure that they are not subject to sudden economic disaster because of bankruptcies that might take place among their licensors before they can find substitutes for the licensed products. Even more important is our ability to continue to use the license as an instrument of commerce. The benefits are clear: it gets the best ideas to the customer at the most reasonable cost. It allows the customer to determine which ideas to pay for and which to reject. The technology license is a key building block that has enabled the U.S. high technology industry to thrive and prosper.

I urge you, with all due haste, to ensure that the license is once again free from the enormous threat that hangs over it today. I urge you to pass H.R. 4657 and thus to restore the license to a secure place as a legal girder to U.S. high technology.

Mr. EDWARDS. Thank you very much, Mr. Burger.

Before we recognize Mr. Hemnes, would you introduce for the record your colleague?

Ms. SHEA-STONUM. Good morning, Mr. Edwards. My name is Marilyn Shea-Stonum. I'm a partner with the law firm of Jones, Day, Reavis & Pogue. I have served as counsel to the Bankrupt Licensors Coalition in working with a number of interested groups—the National Bankruptcy Conference, the American Bankruptcy Institute, the Business Bankruptcy Section of the American Bar Association, the Patent Section of the American Bar Association, and the Science and Technology Section of the American Bar Association—trying to get input from those various interested groups in working towards some solution to the *Lubrizol* problem. I was also counsel of record to *Lubrizol* in the Fourth Circuit decision.

Mr. EDWARDS. Thank you, and welcome.

We will now hear the testimony of Thomas M.S. Hemnes of Foley, Hoag & Eliot.

Mr. HEMNES. Thank you, Mr. Chairman.

My name is Tom Hemnes. I am an attorney, practicing law in the city of Boston. I am testifying in support of the general proposition that *Lubrizol* has created a problem that needs to be addressed by Congress, but in opposition to the means of addressing that problem that is represented by H.R. 4657.

To make this point, I would like to begin by saying it is important to bear in mind, in my view, the central importance of section 365 of the Bankruptcy Code to the successful reorganization of a debtor. To return to the example that Mr. Burger was just giving, of the small entrepreneurial individual who works in his basement and creates a computer software program, I think it is quite possible that such a person might enter into a license agreement which, in retrospect, would prove to have been ill-advised. It is in circumstances like that that an individual or, indeed, a small corporation, a partnership or other business entity, might become involved in bankruptcy proceedings.

When such a person becomes involved in bankruptcy proceedings, it is absolutely essential that he or she or it be able to discharge burdensome property that belongs to the person. Burdensome property, under the Bankruptcy Code, includes not only things like old automobiles that don't work and need to be fixed, it also includes old license agreements, old distributorship agreements, old research and development partnerships, that don't work and need to be fixed. Under section 365 of the Bankruptcy Code, the trustee has the power to make that decision and to, in appropriate circumstances, decide that it would be harmful to the estate of the debtor to continue with the license.

It is undoubtedly the case that the rule of *Lubrizol* creates a problem for the licensing of technology because it threatens licensees with the loss of their right to use the technology. I believe that that does need to be fixed and that the fix has to come from Congress.

I believe, though, that H.R. 4657 commits at least three really rather fundamental problems in addressing the issues created by *Lubrizol* and I would like to quickly summarize those.

The first of those three problems is that it assumes that in every license transaction the fundamental deal is a right to use in exchange for an obligation to pay. It is my experience that this would be the exception rather than the rule in intellectual property licensing. I have provided with my written testimony a couple of examples of actual license agreements to give your subcommittee an idea of just how complex these transactions frequently become.

In the context of such a complex transaction, to extract a simple right to use in opposition to an obligation to pay is likely to create inequities for one party or the other because they had both anticipated when they entered into the agreement that they would be getting much more from the opposite party to the transaction.

My second objection to the proposed legislation is that it is overbroad. It assumes that in every case the right of the licensee should prevail over the need of the licensor to reorganize itself. In my view, there are a number of cases in which that is the case. *Lubrizol* itself may have been one such case. But there are likely to be many other instances in which the burden on the licensee of a rejection will be less than the harm to the licensor of being prevented from reorganizing itself, from getting out from under the improvident contract that I described at the beginning of my testimony.

My third objection to H.R. 4657 is that it provides no specific protection for trade secrets that are included in a license agreement. I think that it's fair to say that one of the principal concerns of the drafters of this legislation is in the area of software licensing, and I think it's also fair to say that computer software is usually protected as a trade secret, in addition to possible copyright and patent protection for the same software. Under the proposed legislation, even if the licensee has already agreed to protect the confidentiality of the software, the licensor would be obligated to go into the bankruptcy court under section 107 of the Bankruptcy Code and petition the court to protect the software as a trade secret. I think that's unfair to the licensor. I think it's extremely unfair to a prime licensor, who may have granted the license to the bankrupt party, where the bankrupt party is sublicensing rights to a third party.

I believe, as I said before, that there are ways of addressing the *Lubrizol* problem that wouldn't create these inequities, and I have suggested two possibilities in the written testimony that I have provided to the subcommittee.

One of those two ways would be to model the relief on section 1113 of the Bankruptcy Code, which I'm sure you're familiar with, and which Congress recently enacted, in the context of collective bargaining agreements. If one modeled the relief on that section, one would require the bankruptcy court to balance the interests of the licensee against those of the licensor before permitting rejection. One might even require the parties to attempt to renegotiate a new and more fair license agreement, again on the model of section 1113.

A second alternative that I suggest in my written testimony is that Congress could create a category of protected rights. These rights would be a simple executory contract of the type that the current legislation assumes exists in every license agreement but, as I have testified, probably does not exist in many license agreements. Where such a protected right has been incorporated into a license agreement, it would be protected against rejection. On the other hand, where it would not be appropriate to incorporate it into a license agreement, presumably the parties wouldn't agree to it and, therefore, the legislation I have proposed would not apply.

I would respectfully submit that either of these alternatives would strike a better balance between the interests of the licensee and licensor in situations of this kind.

Thank you again for giving me this opportunity to testify to your subcommittee.

[The statement of Thomas M.S. Hemnes follows:]

TESTIMONY OF
THOMAS M.S. HEMNES
BEFORE
THE SUBCOMMITTEE ON MONOPOLIES AND COMMERCIAL LAW
OF THE
HOUSE OF REPRESENTATIVES
COMMITTEE ON THE JUDICIARY
REGARDING
H.R. 4657

A Bill to amend title 11 of the United States Code with respect to the rejection of executory contracts licensing rights to intellectual property

JUNE 3, 1988

SUMMARY OF TESTIMONY

There is no question that the Lubrizol case has created a problem for some intellectual property licensors and licensees. The question is not whether something needs to be done in response, but what, and by whom.

H.R. 4657 is not the answer. It 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.

There are many alternatives to H.R. 4657 that would cause far less harm to fundamental bankruptcy policies. The most equitable solution would be to require bankruptcy courts to consider the impact of rejection on intellectual property licensees before approving rejection, and to structure relief following rejection to minimize the impact on such licensees. This approach could be modeled on Section 1113 of the Bankruptcy Code, which Congress recently enacted to ensure that union members' interests are considered before collective bargaining agreements are rejected.

A second legislative alternative is to permit a licensee to retain rights ("Protected Rights") in intellectual property only where the rights are nonexclusive and are tied solely to the licensee's obligation to pay and to protect the intellectual property. This would leave contracting parties the freedom to decide whether to incorporate such "Protected Rights" into their licenses. When they have done so, the licensee could elect to continue with the Protected Rights following rejection of the over-all license by a trustee for the licensor.

This latter alternative is the closest to H.R. 4657. It would allow parties to provide the certainty against rejection that some licensees demand, but at the same time retain the principle of mutuality of obligation and thereby avoid the inequities and overbreadth of the current bill.

Mr. Chairman:

Please allow me to begin by expressing my appreciation at this opportunity to testify before your Subcommittee regarding H.R. 4657. This is an important bill which would, in my judgment, substantially alter the balance of equities between a debtor in bankruptcy, the debtor's creditors and the debtor's licensees. I hope by means of this testimony to provide information which will assist your Subcommittee in its consideration of this proposed legislation.

By way of introduction, I am an attorney practicing in Boston, Massachusetts, where I am a member of the law firm Foley, Hoag & Eliot. I also teach intellectual property law as a Lecturer at Northeastern University School of Law. I have published numerous articles on a variety of legal subjects. The most pertinent is an article I published last year with one of my colleagues entitled The Bankruptcy Code, The Copyright Act, and Transactions in Computer Software, 7 Computer/Law Journal 327.

I am appearing solely on my own behalf, and not as a representative of any interested group or client.

I. Bankruptcy Policy

H.R. 4657 is largely a response to a celebrated case decided by the Fourth Circuit Court of Appeals in 1985 entitled Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.[1] In Lubrizol, the debtor (Richmond Metal Finishers ("RMF")) had granted Lubrizol a nonexclusive license to use a proprietary metal coating process. After filing for reorganization under Chapter 11 of the Bankruptcy Code, RMF decided that an exclusive license would fetch a better price for its technology. It therefore petitioned the bankruptcy court under Section 365 of the Bankruptcy Code[2] for leave to "reject" its license to Lubrizol.

A contract can be rejected under Section 365 if it is "executory", which generally means that there are material, unperformed obligations on both sides. In the Lubrizol case, RMF was obligated to defend any patent infringement suit regarding the licensed technology, to indemnify Lubrizol for losses caused by any misrepresentation or breach of warranty by RMF, and to give Lubrizol the benefit of a "most favored licensee" clause.

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1 756 F.2d 1043 (4th Cir. 1985), cert. denied, 106 S.Ct. 1285 (1986), rev'g In re Richmond Metal Finishers, 38 Bankr. 341 (Bankr. E.D. Va. 1984).

2 11 U.S.C. §365 (1986) (citations to Title II to the United States Code may be referred to hereinafter the "Bankruptcy Code" or the "Code").

Lubrizol was required to pay royalties to RMF based on quarterly written reports. Finding these obligations sufficient to make the license executory, the Fourth Circuit held that the debtor could reject the license and thereafter prevent Lubrizol from using the licensed technology.

There is no doubt the Lubrizol case has created significant hurdles for some vendors and licensees of intellectual property. The possibility that a licensor could file bankruptcy and thereafter cut off a licensee's access to vital technology is very chilling to certain types of business transactions.

It is important, however, that any legislative response to Lubrizol be tailored to the more acute problems created by that case, and not extend its reach to situations in which Section 365 is vital to the reorganization of bankrupt vendors. My basic point is that H.R. 4657 casts its net wider than is necessary to solve the Lubrizol problem.

To make this point it will be necessary to provide a very brief description of the purposes and policies of bankruptcy proceedings. It is a popular misconception to say that bankruptcy proceedings are a debtor's remedy. It is true that some features of bankruptcy proceedings -- notably the "automatic stay" of Section 362 of the Bankruptcy Code -- provide the debtor relief from the immediate demands of its creditors. However, the goal of this relief is not to prevent the creditors from collecting on their claims. Instead, it is to prevent any one of them from collecting disproportionately from the debtor's estate, and to prevent the premature liquidation of particular claims from interfering with the successful reorganization of the debtor.

Thus, bankruptcy actually functions as a clearing house for creditors' claims. Beginning with the proposition that all of the unsecured creditors cannot be paid in full, bankruptcy provides a means to ensure that they are paid ratably and in the largest percentage possible under the circumstances.[3]

The bankruptcy trustee has the responsibility to maximize the value of the debtor's estate and then distribute that value equitably among the creditors. In some cases, the best way to maximize the value of the debtor's estate is to preserve the debtor as a on-going business under Chapter 11 of the Bankruptcy Code; in other cases, liquidation under Chapter 7 is in order. In either case, the Trustee has the power and duty to get rid of ("abandon") any property that costs more to maintain than it is worth, since such property represents a net drain on the creditors' recovery. 11 U.S.C. §554.[4]

3 See Jackson, Bankruptcy, Non-bankruptcy Entitlements and the Creditor's Bargain, 91 Yale L.J. 857 (1982).

4 After the filing of bankruptcy proceedings, the debtor's estate (footnote continued)

The debtor's estate includes not only tangible assets such as real estate and personal property, but also all of the debtor's contract rights. Just as an old auto can be far more costly to maintain than it is worth, the cost of compliance with an improvident contract can easily exceed its benefits. It is therefore in the interest of the creditors to "abandon" such a contract by rejection under Section 365. Rejection cuts off the contractual obligee's right to obtain specific performance and thus converts the debtor's obligation to perform into a general unsecured claim which may be treated on a par with other unsecured claims. 11 U.S.C. §502(g). If the trustee did not have the power to reject a burdensome executory contract, then an unsecured obligee under an executory contract would in effect be given a right to drain the debtor's assets to the detriment of other unsecured creditors.

The facts of the Lubrizol case itself provide a good example of how Section 365 of the Bankruptcy Code directly pursues these underlying policies. It will be recalled that the license in that case imposed very limited executory obligations on the debtor RMF, but that they included an obligation to defend patent infringement suits. It is not at all uncommon for the defense of a patent infringement suit to cost between $250,000 and $1.5 million in fees for attorneys, expert witnesses and court costs. If RMF could not have rejected its license to Lubrizol, and if a patent infringement suit were filed regarding the licensed technology, Lubrizol could have compelled RMF to defend the suit. The administrative expense of such a suit could easily wipe out a debtor's entire estate, leaving nothing for its other creditors, while providing a windfall for a licensee such as Lubrizol.

Rejection under Section 365 does not extinguish RMF's obligation to defend our hypothetical patent infringement suit. Instead, it puts the cost of such a defense on a par with RMF's other unsecured obligations. The Bankruptcy Code accomplishes this by preventing Lubrizol from obtaining "specific performance" -- i.e., an order forcing RMF to actually defend the infringement claim -- and substituting instead a general, unsecured claim for the cost of such a defense. See 11 U.S.C. §502(g).

The trustee's power to reject a burdensome executory contract under Section 365 is thus central to the administration of a debtor's estate. It is part of the trustee's more general authority (and, indeed, responsibility) to get rid of "property" that is burdensome to the debtor's estate. It is also necessary to the realization of the basic tenet of bankruptcy justice, which is that all creditors of the same class should be treated equally.

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is administered by either a debtor in possession, an independent person (trustee) appointed by the bankruptcy court or, in some jurisdictions, by the United States Trustee. See 11 U.S.C. §§1101(a), 1104, 1501, 15108(a). All three have the same powers for purposes of the matters discussed in this testimony, and all three will be referred to as the "trustee."

Trimming the trustee's power makes it harder to administer the estate equitably and reduces the recovery of unsecured creditors.

II. Objections to H.R. 4657

A. H.R. 4657 Would Create Substantial Inequities

My most fundamental disagreement with H.R. 4657 is that it abrogates one of the basic principles of equity: mutuality of obligation.[5] Under this principle, a debtor that decides to assume an executory contract must first make good any outstanding defaults under the contract and must provide adequate assurance that is will perform its future obligations under the contract. 11 U.S.C. §365(b). By contrast, a licensee that elects to "retain" rights under H.R. 4657 is excused from any obligation other than the obligation to make payments, and even this obligation may be subject to the defense that the debtor is materially in default of its obligations.

The Value-Added Resale and Distribution Agreement attached as Appendix A provides a vivid example of the inequities that H.R. 4657 would create. This is an actual agreement currently in use.[6] Under it, Vendor appoints Distributor as Vendor's distributor within designated areas for Vendor's computer-aided software engineering ("CASE") program called "Vendor/Work" (Section 3). Vendor also grants Distributor an option to acquire a perpetual, royalty-free license to use and market Vendor/Work if Distributor's royalty payments exceed $XX million (Section 13). Distributor, for its part, agrees to pay Vendor certain up-front fees, plus a sublicense fee for each copy of Vendor/Work that Distributor sells (Section 7). The agreement includes a variety of other mutual obligations, including a complicated interplay of software development, sales and support services (see Sections 4 and 5).

Like many distribution and development agreements, this one includes cross-licenses of the parties' intellectual property rights in computer programs and other materials (see Section 2 of the agreement). The Vendor licenses the Distributor to use and to sublicense Vendor's computer programs (Sections 2.3, 2.4, 2.5, and 2.7), and Distributor licenses Vendor to use Distributor's computer programs for Vendor's internal purposes and for research and development purposes (sections 2.1 and 2.2). Because it contains intellectual property licenses, the distribution agreement would clearly fall within H.R. 4657's definition of an "executory contract under which the debtor is the licensor of

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[5] See 2 Collier on Bankruptcy §365.01 at 365-12 (L. King 15th ed. 1987).

[6] For the sake of confidentiality, I have deleted from Appendix A names, schedules and other identifying materials.

rights to intellectual property," regardless of which party went bankrupt.

Bad distribution agreements are, in my experience, a frequent cause of financial difficulty for high technology companies. If Vendor went bankrupt, it is quite possible that Vendor's trustee would wish to reject this agreement. Under H.R. 4657, Distributor could elect to "retain its rights in the intellectual property" following rejection by Vendor's trustee. This would permit Distributor to continue to exercise its rights to market and sublicense the Vendor's product under Section 2.7 of the agreement for the balance of its term. It is arguable that it would also permit Distributor to exercise its option to acquire a perpetual, royalty-free license under Section 13.

Once the Vendor's trustee had rejected the contract, the trustee would have no continuing obligation under H.R. 4657 to perform executory obligations such as training, enhancements, technical support, and software maintenance services. On the other hand, such services are required by Section 5 of the agreement, and Vendor's failure to perform such obligations would therefore constitute a breach of the agreement by Vendor.[7] Under section 9.2.2 of the agreement, Distributor could use this breach to terminate the license granted by Sections 2.1 and 2.2 of the agreement to use Distributor's technology for development and other purposes. Distributor could also use the breach to terminate its own obligations to meet sales targets under Section 4.4 of the agreement, to service Vendor's customers under section 4.5 of the agreement, and even to pay royalties owing under Section 7.

Vendor's right of access to Distributor's technology, Distributor's obligation to sell Vendor's product and Distributor's obligation to service Vendor's customers were undoubtedly important considerations in setting the amount of royalties payable under the license. For this reason, Distributor's obligation under H.R. 4657's proposed Subsection 365(n)(2)(B) (hereinafter "Proposed Section 365, etc.") to continue to make payments under the license would give Vendor far less than the benefit of its bargain. The existence of a distributor having such a sweetheart deal would be unfair to the debtor and its other distributors and other creditors. It is the last thing that a bankrupt intellectual property licensee needs, and yet it is exactly what H.R. 4657 would create.

Inequities of this type would be common if H.R. 4657 were enacted into law. They would arise whenever part of the consideration for an intellectual property license is a cross-license, an obligation to market a product, an obligation to

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[7] H.R. 4657 seems to imply that the licensee cannot treat the rejection of an executory intellectual property license as a breach under Section 365(g) of the Bankruptcy Code if the licensee has elected to retain rights under Proposed Section (n)(1)(B).

perform development services, or any other nonmonetary benefit to the licensor. In my experience, such features are the rule and not the exception in intellectual property licensing.[8]

To give another example of the inequities H.R. 4657 would cause, I have attached as Appendix B a second license agreement entitled "Agreement for ABC Software Systems." This is another real agreement, currently in use, from which identifying materials have been deleted. Under the agreement, ABC, the licensor, permits the licensee to use certain computer programs created by ABC. The agreement also grants the licensee a sublicense covering an underlying program, which I have called, for the sake of confidentiality, the Model XXX.

The failure of H.R. 4657 to address the licensee's continuing obligations (other than for payment) would cause substantial inequities in connection with Sections 7 ("Warranties; Limitations"), 8 ("Patent and Copyright Indemnification") and 9 ("Term; Termination") of this agreement. All of these are absolutely standard terms in intellectual property licenses.

As to Sections 7 and 8, the basic question is whether these provisions survive the process of rejection followed by a retention of rights. It seems clear that the licensee could not get specific performance of the debtor's obligations to "correct or replace" software under its warranty obligations in Section 7, and to defend certain claims under Section 8. The more difficult question, though, is whether the debtor's failure to meet these obligations could be asserted as an affirmative defense by the licensee in an action by the debtor for payments due under Proposed Section 365(n)(2)(B). If the debtor's default under such clauses provides a defense, then as a practical matter Proposed Section 365(n)(2)(B) is likely to become a dead letter and licensees will usually exercise their rights under H.R. 4657 for free. If the default does not provide a defense, then the requirement of payment under Proposed Section 365(n)(2)(B) will in many cases require licensees to make payments even under circumstances where the licensed intellectual property proves to be worthless because of warranty defects or infringement liability to third parties.

Section 9 is also highly problematic under H.R. 4657. The question is whether the debtor retains its right to terminate the contract under Section 9.2 on the ground of the licensee's default, and whether, in the event of such termination, the debtor can compel the licensee to cease using the intellectual property under Section 9.3. Suppose, for example, that the licensee makes all payments due under the contract in compliance with Proposed

8 By contrast, payments "in kind" are, I believe, rare in real estate leasing and time share interest transactions. For this reason, the provisions of Section 365(h) of the Code regarding real estate leases and time share interests on which H.R. 4657 is modeled cause far fewer inequities than H.R. 4657 would cause.

Section 365(n)(2)(B), but improperly decomplies object code (i.e., takes the program apart to see how it works) in violation of Section 6.5 of the contract. Can the debtor terminate the licensee's retention of rights under Proposed Section 365(n)(1)(B)?

This question raises the more general issue left entirely undecided by H.R. 4657: whether a licensee who has elected to retain rights is bound by the rejected license agreement, or whether the licensee instead enjoys a statutory right to use certain property subject to a sort of compulsory license fee. If there is an enforceable agreement, then what H.R. 4657 really means is that contracts that include intellectual property licenses cannot be rejected without the consent of the nonbankrupt contracting party. On the other hand, if there is not a contract, then H.R. 4657 leaves the trustee for the licensor completely without any remedy for breaches by a licensee who has elected to retain rights, with the sole exception of breaches caused by failure of the licensee to pay.

B. H.R. 4657 Is Overbroad

As applied to a simple license of the type involved in Lubrizol, H.R. 4657 is not a bad piece of legislation. It would have allowed RMF's trustee to "reject" the license, thus converting Lubrizol's potential claims for infringement defense and indemnification into general, unsecured claims that can be paid out of the debtor's estate proportionately with other such claims. At the same time, it would have permitted Lubrizol to elect to continue to use the licensed technology on a nonexclusive basis, as long as Lubrizol paid the royalties it had agreed to pay.[9] Altogether a very fair-seeming result.

Unfortunately, simple licenses of the type involved in Lubrizol are the exception rather than the rule. Intellectual property rights permeate modern commercial transactions. There is scarcely an asset purchase agreement, a research and development contract, a distributorship agreement, or even a contract for the sale of goods that does not include a license of intellectual property. H.R. 4675 would make many of these agreements difficult for a trustee to reject. In the vast majority of such transactions, outright termination of the non-bankrupt party's right to use licensed technology is unlikely to be fatal to the licensee. At the same time, interference with the debtor's inability to reject such contracts can be potentially catastrophic to the successful reorganization of the debtor.

The distributorship agreement attached as Appendix A is an example of a contract to which H.R. 4657 should not, but does, apply. It has already been observed that the Distributor could

9 As discussed above, Lubrizol might have escaped its obligation to pay by forcing RMF to sue and then asserting the affirmative defense that RMF was in breach of its obligations under the contract.

elect to retain its right to sublicense Vendor's product following rejection of the contract by Vendor's trustee. In exchange, Distributor would be required to continue to make payments owing under the contract, but it would probably be excused from its obligations to meet sales targets and to provide adequate service to Vendor's customers.[10]

In effect, H.R. 4657 would give the distributor a statutory sinecure within the geographic area covered by the distributorship agreement. As a practical matter, the existence of an entrenched distributor able to sell Vendor's program at a low royalty rate without any marketing or service obligations would make it virtually impossible for the trustee to negotiate a better distributorship arrangement with anyone else within Distributor's territory. The trustee's hands would be tied so completely that it could spell the death knell for the Vendor's reorganization. The only alternative would be for the trustee to affirm the distributorship agreement -- which could well be one of the business mistakes that forced Vendor into bankruptcy proceedings in the first place.

A research and development joint venture is another example of a transaction to which H.R. 4657 would inappropriately apply. In such an arrangement, each of the contracting parties might license the others to use of its intellectual property for research and development purposes. The essence of the transaction is an agreement to pool technology and then share in the intellectual property rights to any new developments. If one of the parties to such an arrangement went bankrupt and attempted to avoid its executory obligations by rejection, the other parties could elect to retain their licenses of the bankrupt party's intellectual property. At the same time, they could refuse to share the results of their research and development activities on

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10 The distribution agreement attached as Appendix A raises a related problem under H.R. 4657: how to deal with a contract that covers both "intellectual property" as defined in Proposed Section 101(52) and trademark rights. H.R. 4657 does *not* include trademarks within its definition of intellectual property. Thus, Distributor could not elect to retain its license of Vendor's trademarks under Section 2.8 of the agreement. However, Section 2.7.2 of the agreement requires Distributor to use Vendor's trademarks in marketing the licensed product. Does this mean that Distributor can elect to continue to use the trademarks even though the Distributor has no continuing obligation to comply with Vendor's quality standards, including those in Section 4 of the agreement even though this could result in the granting of a "naked" license that would void vendor's trademark rights? Or does it mean that Distributor cannot elect to continue to sublicense Vendor's programs, notwithstanding an election to retain such rights? Or does it mean that Distributor may begin applying some other trademark to Vendor's products? Any one of these alternatives seems equally undesirable.

the ground that the bankrupt had failed to meet its executory obligations for research and development.

In short, in the context of a research and development joint venture of the type described above, H.R. 4657 would present the trustee with a choice between allowing the other parties to raid the debtor's storehouse of intellectual property without obligating them to grant any rights in return, or affirming the contract and incurring research and development expenses as an administrative expense of the debtor's estate. Either alternative could be damaging to the debtor's chances at reorganization and highly unfair to the debtor's other creditors.

C. H.R. 4657 would Jeopardize Rights in Intellectual Property and Chill Sublicensing

One of the most important executory obligations imposed by typical intellectual property licenses is the obligation to protect the licensed technology as confidential information (i.e., as a trade secret). An example of a clause imposing this obligation is Section 6 of the agreement I have attached as Appendix B.

H.R. 4657 gives no assurance that the licensee would be required to abide by confidentiality obligations such as those found in Section 6. Instead, protection of the trade secret status of the licensed programs would require a petition for relief under Section 107(b) of the Bankruptcy Code.

While it might be argued that it would not be particularly unfair or burdensome to require the debtor to take the affirmative step of filing such a petition, it seems highly unreasonable to impose this burden -- as well as the risk that the court might deny the petition -- on the "prime" licensor DEF Corporation, which is neither bankrupt nor a party to the bankruptcy proceedings.

In the case of the actual business transaction to which Appendix B relates, the sublicensed program called Model XXX is a highly confidential and valuable database management system, individual licenses for which cost in excess of $100,000. It is unthinkable that DEF Corporation would permit ABC Systems to sublicense this program if there would be the slightest chance that the sublicensee could continue to use it without being bound by Section 6 of this Agreement.

Sublicensing of the type found in this agreement is very common. By jeopardizing the ability of the ultimate licensor to protect its technology in the hands of sublicensees, H.R. 4657 would tend to discourage sublicensing and thus interfere with transactions of the very type it is intended to facilitate.

III. Alternatives to H.R. 4657

For the reasons described above, I am persuaded that H.R. 4657 would create many more problems than it would solve. There are several alternatives to H.R. 4657 that would, in my judgment, address the problems created by Lubrizol with far less collateral damage to other important bankruptcy concerns.

The first alternative is to do nothing. This is not as bad as it sounds. It would give the courts and attorneys for licensees and licensors more time in which to devise accepted means of accommodating the needs of intellectual property licensees within the existing framework of bankruptcy proceedings.

We have already begun to see this process working itself out. Some courts have shown themselves willing to curtail the trustee's power of rejection in situations where rejection would cause more harm to the licensee than it would cause benefit to the estate of the debtor.[11] At the same time, the escrow agreement -- under which the licensor's intellectual property, or embodiments of it, is placed in the hands of an escrow agent for distribution to licensees in the event of the licensor's default -- is undergoing a process of refinement that promises to make it a more effective barrier against bankruptcy trustees.[12] Notable refinements include coupling the escrow with a security interest, or styling it a trust agreement, under which the trustee holds a security interest in the licensor's intellectual property and acts very much like the traditional indenture trustee.

The objection to this most conservative alternative is not that it will not work: I am confident that it will work, eventually. The objection, rather, is that it will take time. There is a strong -- and probably well-founded -- sense within the intellectual property bar that some more immediate relief is required.

To the extent that quicker relief is needed, a more balanced legislative reaction could be modeled on the protection for collective bargaining agreements found in Section 1113 of the Bankruptcy Code. Thus, Congress could require bankruptcy courts to consider the impact of rejection of an intellectual property

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11 See, e.g., In re Chi-Feng Huang, 23 Bankr. 798 (9th Cir. 1982); In re Select-a-Seat Corp., 256 F.2d 290 (9th Cir. 1980)(rejection allowed, but licensee's right to use technology unaffected), Infosystems Technology, Inc. v. Logical Software, No. 87-0042, slip op. (D. Mass. June 27, 1987), In re Meehan, 59 Bankr. 380 (E.D.N.Y. 1986); In re Midwest Polychem, Ltd. 61 Bankr. 559 (Bankr. N.D. Ill. 1986); In re Chipwich, Inc. 54 Bankr. 427 (S.D.N.Y. 1985); In re Turbowind, Inc. 42 Bankr. 579 (Bankr. S.D. Cal. 1984); In re Petur U.S.A. Instrument Co., Inc., 35 Bankr. 561 (Bankr. W.D. Wash. 1983).

12 See, e.g., Matter of Newcomb, 744 F.2d 621 (8th Cir. 1984).

license on the licensee before approving rejection, and allow the licensee to continue to use the licensed property for limited periods or under limited conditions if necessary to mitigate the damage caused by rejection.

The foregoing alternative has the advantage of giving the bankruptcy court the greatest possible latitude in which to find a solution that is fair to all. On the other hand, it has the disadvantage of unpredictability. Some licensees may feel that they cannot tolerate even a remote possibility that a court might hold against their right to continue to use licensed technology. The mere chance of an unfavorable result would, it is argued, chill licensing in a wide range of transactions.

I believe that arguments of this type reflect a desire by licensees for Congress to provide more certainty than is realistically attainable in the context of bankruptcy proceedings. However, it is possible to structure a legislative response that would provide a larger measure of certainty than one modeled on Section 1113 of the Bankruptcy Code.

The basic error committed by H.R. 4657 is that it assumes that one can extract a simple, essentially nonexecutory license (a right to use, coupled with an obligation to pay) from every license agreement. As the examples I have given demonstrate, this simply is not the case. By imposing such a license on parties who have not agreed to it, H.R. 4657 violates the principle of mutuality of obligation. This results in the bill's proclivity for inequitable results.

A better approach would be to give the licensee an option to retain its rights under a simple, nonexecutory license only where the parties have already incorporated such a license into their business relationship. This could be accomplished by permitting a licensee to retain its licensed rights only if they meet certain criteria.

I would suggest the following criteria for a licensed right of the type that a licensee could elect to retain following rejection (hereinafter, a "Protected Right"): a nonexclusive[13]

[13] The nonexclusive right could be a part of a larger exclusive license. I would not, however, protect the right of exclusivity against rejection for several reasons. First, outstanding exclusive rights are likely to constrain a trustee's efforts at reorganization much more than outstanding nonexclusive rights. Second, the principal fear of licensees under Lubrizol is loss of access to license technology; preserving a nonexclusive right would be sufficient to address this concern. Third, there are a variety of means by which exclusive licensees can protect themselves under existing law. An exclusive license of a copyrighted work can probably be protected against a bankruptcy trustee by recording under Section 205 of the Copyright Act. An (footnote continued)

right to use or to sublicense intellectual property (as defined in H.R. 4657) owned by the licensor under which the licensor's only substantial executory obligation is to permit the licensee to exercise such right and the only grounds on which such right may be terminated are the licensee's failure to make payments or failure to protect the property against loss or misappropriation (e.g., by failing to place appropriate copyright notices on copies of the property or by failing to comply with nondisclosure or noncompetition obligations).

Given this definition, Section 365 could provide that wherever a contract that includes such a Protected Right has been rejected by a trustee for the licensor, the licensee may elect to retain the Protected Right. Upon such election, the provisions of the rejected contract creating such a right and the associated obligations to pay and to protect the licensed intellectual property would be severed from the balance (if any) of the agreement and remain in full force and effect, notwithstanding the rejection of the agreement.

Such a-provision would have the certainty that is provided by H.R. 4657. It would also have many advantages over H.R. 4657. It would, in the first place, avoid the inequities H.R. 4657 would create by preserving the principle of mutuality of obligation. It would also avoid the overbreadth of H.R. 4657 because licensors would be unlikely to agree to the creation of a "Protected Right" in highly interdependent contexts such as distributorships and research and development projects where a substantial portion of the consideration for the license grant is nonmonetary. It would, finally, protect "prime" licensors' rights in their intellectual property by requiring sublicensees who wish to be protected from rejection to obtain a separate license from the prime licensor (just as a real estate lessee obtains a separate "ground lease" from its ultimate lessor).

In sum, the proposed creation of a category of "Protected Rights" would invite businesses to decide for themselves and in advance of bankruptcy whether it is commercially reasonable (and therefore equitable) to create the kind of right H.R. 4657 would impose on them by legislative fiat. It is respectfully submitted that this would be manifestly more equitable and workable than it would be for Congress to decide for the parties what is best for them, which is exactly what H.R. 4657 purports to do.

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exclusive patent or trade secret license can be recorded as a transfer, with the licensor/transferor retaining a reversionary interest, secured by a security interest. Fourth, where an exclusive licensee fails to avail itself of these means of protection, it would not be protected against rejection any more than a secured party that fails to perfect its security interest should be protected against being treated as an unsecured creditor.

IV. Conclusion

To paraphrase Samuel Johnson, the possibility of a bankruptcy concentrates a licensee's mind wonderfully. Lubrizol is a sobering reminder that it is dangerous for any business to become entirely dependent on a single vendor, or on a single item of licensed technology.

Considered in the long run, I am not sure that this is a bad thing. Neither H.R. 4657, nor any of the alternatives that I have described above, could protect an intellectual property licensee against the loss of a support, consultation, maintenance, updates, enhancements, improvements, and a host of other routine services that a bankrupt licensor can no longer afford to provide. Preservation of a licensee's right to use licensed technology under any of these alternatives will in many cases provide no more than a breathing space within which the licensee must find alternative sources of technological support.

H.R. 4657 would purchase some relief for licensees, but at too high a cost. I respectfully submit that either of the two alternatives described above would strike a better balance between the interests of intellectual property licensees, a bankrupt licensor, and the bankrupt's creditors.

Thank you again for giving me this opportunity to share my views with your Subcommittee.

Appendix A

VALUE ADDED RESALE AND DISTRIBUTION AGREEMENT

This Agreement made this ______ day of __________, 198_, by and between Vendor Technologies Inc. (hereinafter "Vendor"), a corporation incorporated under the laws of the State of Delaware, United States of America, having its principal place of business at ______________________, and Distributor, Inc. (hereinafter "Distributor"), a corporation organized and existing under the laws of _________________, having its principal place of business at _______________.

W I T N E S S E T H:

WHEREAS, Vendor is engaged in the design and manufacture of "Vendor/WORK" (as hereinafter defined) and has the right to grant licenses and appoint distributors therefor;

WHEREAS, Distributor is engaged in the design, manufacture and marketing of "Product" (as hereinafter defined);

WHEREAS, Distributor desires to act as non-exclusive distributor of Vendor/WORK in connection with Product in "Region A" and "Region B" (as hereinafter defined); and

WHEREAS, Vendor and Distributor desire to develop modifications and enhancements to Vendor/WORK and Product that will result in the increased value of Vendor/WORK and Product;

NOW, THEREFORE, for and in consideration of the mutual promises and covenants herein contained and other good and valuable consideration, the parties hereto agree as follows:

1. Definitions

1.1. "Vendor Development Materials" shall mean the materials listed in Schedule A, Part 2.

1.2. "Customers" shall mean end users of Vendor/WORK in Region A or Region B.

1.3. "Connecting Software" shall mean software developed by Distributor, which shall accomplish the following:

1.3.1. Generate Product schemas from Vendor/WORK/IM models;

1.3.2. Integrate new data dictionary forms into Vendor/WORK in order to collect Product-specific information and add to Product design database; and

1.3.3. Port Product used with Vendor/WORK to the hardware platforms identified in Schedule A, Part 1.

1.4. "Internal Copies" shall mean a copy or copies of Vendor/WORK provided to Distributor or a copy or copies of Product or Connecting Software provided to Vendor, where such copies are provided solely for internal operation pursuant to the licenses granted in Sections 2.2 and 2.4.

1.5. "Product" shall mean the products of Distributor listed in Schedule B, Part 1.

1.6. "Region A" shall mean the countries identified in Schedule D, Part 1.

1.7. "Region B" shall mean the countries identified in Schedule D, Part 2.

1.8. "Distributor Development Materials" shall mean the materials listed in Schedule B, Part 2.

1.9. "Software License Agreement" shall mean an agreement substantially in the form attached hereto as Schedule C, as such form may be amended by Vendor from time to time, or such other form satisfactory to Vendor.

1.10. "Vendor/WORK" shall mean the products of Vendor listed in Schedule A, Part 1 in object code.

1.11. "Vendor/WORK Source Code" shall mean Vendor/WORK written in higher-level programming languages, which are intelligible to trained programmers and may be translated into object code for operation on computer equipment through the process of compiling. Vendor/WORK Source Code shall not include code that Vendor licenses from other persons, but does not own all rights to, regardless of whether Vendor incorporates such code into Vendor/WORK.

1.12. "Trademarks" shall mean the trademarks Vendor/WORK, Vendor/WORK/SA, Vendor/WORK/RT, Vendor/WORK/SD, Vendor/WORK/ACCESS and Vendor/WORK/IM.

2. Licenses

2.1. Distributor hereby grants to Vendor and Vendor hereby accepts a non-exclusive license to operate Distributor Development Materials, Connecting Software and Product for the purpose of developing integration and porting facilities for Vendor/WORK and Product.

2.2. Distributor hereby grants to Vendor and Vendor hereby accepts a non-exclusive, perpetual license to operate Product and Connecting Software Internal Copies solely for purposes of Vendor's internal use and Vendor/WORK development, provided that:

2.2.1. Vendor shall not copy, modify, market, sell, license, sublicense, publish, timeshare or disclose any Product Internal Copies;

2.2.2. Vendor shall pay Distributor an annual maintenance fee at the rate set forth in Schedule H for each copy of Product Internal Copies; and

2.2.3. Vendor shall perform obligations substantially the same as the obligations of the Licensee under the Software License Agreement in the form attached hereto as Schedule C as to each copy of Internal Copies. Vendor hereby agrees that so long as it possesses or controls Internal Copies it shall be bound by the Software License Agreement attached hereto as to each such copy as if it had executed such agreement separately for each copy of Internal Copies and its obligations under such agreement shall survive expiration or termination of this Agreement for any reason.

2.3. Vendor hereby grants to Distributor and Distributor hereby accepts a non-exclusive license to operate Vendor Development Materials for the following sole purposes:

2.3.1. developing Connecting Software and Connecting Software and Product modifications and enhancements;

2.3.2. providing Vendor with the following support services related to Connecting Software and Product: debugging, telephone assistance with software operation, maintenance and updating; and

2.3.3. developing or using integration or porting facilities for Connecting Software and Product.

2.4. Vendor hereby grants to Distributor and Distributor hereby accepts a non-exclusive, perpetual license to operate Vendor/WORK Internal Copies solely for purposes of Distributor's internal use and Connecting Software and Product development, provided that:

2.4.1. Distributor does not copy, modify, market, sell, license, sublicense, publish, timeshare or disclose any Internal Copies;

2.4.2. Distributor pays Vendor an annual maintenance fee at the rate set forth in Schedule G, Part 3 for each copy of Internal Copies; and

2.4.3. Distributor performs obligations substantially the same as the obligations of the Licensee under the Software License Agreement attached hereto as Schedule C as to each copy of Internal Copies. Distributor hereby agrees that so long as it possesses or controls Internal Copies it shall be bound by the Software License Agreement attached hereto as to each such copy as if it had executed such agreement separately for each copy of Internal Copies and its obligations under such agreement shall survive expiration or termination of this Agreement for any reason.

2.5. Vendor hereby grants to Distributor and Distributor hereby accepts a non-exclusive license to operate Vendor/WORK Source Code for the following sole purposes:

2.5.1. providing Vendor with back-up support services;

2.5.2. facilitating integration of Vendor/WORK with Product or porting Product to the Vendor/WORK hardware platforms identified in Schedule A, Part 1; and

2.5.3. developing Product modifications and enhancements;

and provided that:

2.5.4. Distributor does not allow access to Vendor/WORK Source Code to anyone other than its employees and Distributor only allows access to its employees who have signed express written agreements not to disclose Vendor/WORK Source Code, which agreements shall be in a form acceptable to Vendor;

2.5.5. Distributor does not copy, modify, market, sell, license, sublicense, timeshare, publish or disclose any Vendor/WORK Source Code;

2.5.6. Distributor does not acquire rights in or to software similar to or competing with Vendor/WORK;

2.5.7. Distributor is not acquired by or merged with a company in competition with Vendor or which produces, markets or distributes software similar to or in competition with Vendor/WORK;

2.5.8. Distributor uses its best efforts to prevent access to or disclosure of Vendor/WORK Source Code to Vendor's competitors, including taking all appropriate actions and precautions; and

2.5.9. During the term of this Agreement and for three years immediately following the expiration or termination of this Agreement for any reason, Distributor does not develop, market or distribute any software similar to or in competition with Vendor/WORK.

2.6. Distributor has no right to use Vendor/WORK Source Code, other than as specifically provided in Section 2.5.

2.7. Vendor hereby grants to Distributor and Distributor hereby accepts a non-exclusive license to demonstrate, market and sublicense Vendor/WORK in Region A and Region B in accordance with Schedule D, Part 3, provided that:

2.7.1. Distributor only sublicenses Vendor/WORK in accordance with the terms and conditions of the Software License Agreement;

2.7.2. Distributor only markets Vendor/WORK in connection with Trademarks; and

2.7.3. Distributor only markets Vendor/WORK in connection with Product or Connecting Software.

2.8. The license granted in Section 2.7 shall also include the right to use Trademarks in connection with marketing of Vendor/WORK provided that:

2.8.1. Distributor shall only use Trademarks in connection with Vendor/WORK provided by Vendor and in accordance with Section 8;

2.8.2. such use of Trademarks shall inure to the benefit of Vendor; and

2.8.3. Trademarks shall remain the exclusive property of Vendor.

2.9. Either party may grant to the other party a license to operate, market or distribute other products as existing or may be developed, provided that the parties first agree to price and other terms and conditions.

3. <u>Appointment and Acceptance</u>

3.1. Vendor hereby appoints Distributor as its distributor for Vendor/WORK subject to the terms and conditions of this Agreement.

3.2. Distributor accepts this appointment and agrees to use its best efforts to promote vigorously the marketing and distribution of Vendor/WORK within Region A and Region B.

4. <u>Distributor Obligations</u>

4.1. Distributor represents that it has and shall maintain for the term of this Agreement the facilities, personnel, knowledge, experience and skill necessary: to develop Connecting Software; to market Vendor/WORK, Connecting Software and Product; to provide services to Customers; and to otherwise carry out its obligations under this Agreement.

4.2. Distributor shall provide Vendor with a reasonable number of Product and Connecting Software Internal Copies, at no license fee to Vendor.

4.3. Distributor shall provide Vendor with adequate Distributor Development Materials and Product and Connecting Software copies and information, including modifications, enhancements and updates.

4.4. Distributor shall at its sole expense provide marketing and sales services in Region A and Region B in accordance with the sales plan attached hereto as Schedule E, including the sales targets and milestones set forth therein, and Schedules D and G.

4.5. Distributor shall at its sole expense provide software maintenance services to Vendor/WORK Customers generally consistent with the training and maintenance offered by Vendor to its domestic customers and at least of the scope of the services described in Schedule F.

4.6. Distributor shall maintain adequately configured computer systems to demonstrate Vendor/WORK.

4.7. Distributor shall develop Connecting Software.

5. <u>Vendor Obligations</u>

5.1. Vendor shall provide training in ________________ as follows: (a) Vendor shall conduct at no charge two courses for a maximum per course of ten core sales and technical specialists appointed by Distributor and (b) Vendor will provide additional courses at Vendor's current price for such courses. Distributor will be responsible for all specialists' salary, travel and living expenses related to training.

5.2. Vendor shall provide Distributor with a reasonable number of Vendor/WORK Internal Copies, at no license fee to Distributor.

5.3. Vendor shall provide Distributor with adequate Vendor Development Materials and Vendor/WORK copies and information for the uses provided in Section 2.3, including providing modifications, enhancements and updates.

5.4. Vendor shall provide to Distributor back up Customer technical support from Vendor's main office in ________________, including providing hot line technical support to Distributor's designated technical support personnel during regular business hours. Vendor shall provide sales support to Distributor's designated sales and technical personnel as set forth in Schedule E.

5.5. At Distributor's request and subject to Customer agreeing to Vendor's standard maintenance agreement, Vendor shall provide software maintenance services for a maximum of one year to Customers that sublicense Vendor/WORK from Distributor, provided that such Customers shall pay appropriate maintenance fees to Vendor and Distributor shall not share in such fees. Maintenance services provided to Customers by Vendor shall be at least of the scope of the services described in Schedule F.

5.6. In order to minimize sales channel conflicts in Region A, Vendor shall pay to Vendor sales personnel commissions, at a rate in accordance with current Vendor practices, for orders in Region A taken by Distributor's sales personnel. Distributor agrees to provide Vendor with the necessary customer information to accurately calculate such commissions to Vendor's sales force and Vendor agrees that such Distributor customer information will be considered confidential.

5.7. Until March 30, 1990, in order to minimize sales channel conflicts in Region B, Vendor shall pay distributors in Region B an amount equal to 15% of a Customer's sublicense fee for each order in Region B taken by Distributor's sales personnel. Distributor agrees to pay Vendor an amount equal to 15% of a Customer's sublicense fee for each such order taken by Distributor in Region B, which amount shall be in addition to payments made under Section 7.

6. Order Procedure and Terms

6.1. Orders for Vendor/WORK on appropriate Vendor order forms shall be placed by Distributor with Vendor. After buy down of prepaid sublicense fees that are prepaid pursuant to Section 7.3, Distributor will make payment to Vendor within 30 days after the date of invoice for Vendor/WORK shipped to Distributor by Vendor. Distributor will provide financial statements and references for the establishment of its initial credit line. Vendor may revoke such cpen account terms should Distributor fail to make payments according to the terms set out above or fail to provide satisfactory financial statements or references, in which event Vendor may require Distributor to accompany its orders with irrevocable letters of credit or impose such other terms as Vendor may deem advisable.

6.2. All shipments of Vendor/WORK shall be F.O.B. Vendor's facility. Distributor will assume all risks of loss or damage upon delivery to the carrier at the point of shipment. Unless Distributor provides specific shipping instructions at the time of order, Vendor will select the carrier and ship on behalf of Distributor to the address set forth in this Agreement. All arrangements for transportation and insurance will be made by Vendor for Distributor's account.

6.3. Vendor reserves the right to cancel any orders placed by Distributor and accepted by Vendor as set forth above, or to refuse or delay any shipment thereof, if Distributor (a) fails to make any payment as provided in this Agreement or in the terms of payment set forth in any invoice or otherwise agreed to by Vendor and Distributor, (b) fails to meet reasonable credit or financial requirements established by Vendor, including any limitations on allowable credit, or (c) otherwise fails to comply with the terms and conditions of this Agreement. The parties agree that Vendor will not provide outdated versions of Vendor/WORK or other Vendor products. If an order is cancelled by Vendor because the requested product is outdated, such cancellation will not be considered a termination (unless Vendor so advises Distributor) or breach of this Agreement by Vendor.

7. <u>Prices, Payment and Prepayment</u>

7.1. Vendor shall invoice Distributor at time of shipment, F.O.B. Vendor's facility in Rhode Island, for all Vendor/WORK shipped. Vendor/WORK sublicense prices and maintenance fees shall be as set forth in Schedule G payable net 30 days, which prices may be revised by Vendor from time to time and which include packaging, but do not include prepaid insurance or transportation charges. In the event that Vendor pays insurance or freight charges, such charges will be invoiced with the software, payable net 30 days.

7.2. Vendor shall have no liability for any sales, property, use or other taxes, customs charges, import fees or other costs assessed or charged by any governmental authority with respect to any sale or licensing of Vendor/WORK hereunder, and Distributor shall indemnify and hold Vendor harmless from and against any liability or obligation therefor.

7.3. Distributor shall prepay Vendor/WORK sublicenses as follows: $X00,000 due and payable upon execution of this Agreement and $X00,000 due and payable upon first shipment of Vendor/WORK, but not later than December 31, 1988.

7.4. Distributor shall annually provide to Vendor audited verification of maintenance fees collected by Distributor.

8. <u>Proprietary Rights</u>

8.1. Distributor acknowledges that all title and interest, including all copyrights, in Trademarks, Vendor/WORK, Vendor/WORK Source Code and Vendor Development Materials are the exclusive property of Vendor. Distributor also acknowledges that Vendor/WORK, Vendor/WORK Source Code, Vendor Development Materials and any other materials received by Distributor and identified by Vendor as proprietary or confidential are proprietary and trade secrets of Vendor (hereafter "Vendor Proprietary Material").

8.2. Distributor agrees not to disclose Vendor Proprietary Material and neither to do nor to permit any act which may in any way jeopardize or be detrimental to the validity of Vendor's patents, copyrights, trade secrets or other rights in Vendor/WORK, Vendor/WORK Source Code, Trademarks, Vendor Development Materials or Vendor Proprietary Material.

8.3. Distributor shall take reasonable precautions to maintain the confidentiality of Vendor Proprietary Material and to protect Vendor's copyrights, patents and trademark, including taking such steps as Distributor takes to protects its own confidential information, copyrights, patents and trademarks.

8.4. No Vendor/WORK shall be transferred to a Customer unless Distributor shall prior to transfer have obtained from the Customer a signed copy of the Software License Agreement, copies of all of which shall be furnished to Vendor.

8.5. Vendor acknowledges that all title and interest, including all copyrights, in Product, Connecting Software and Distributor Development Materials are the exclusive property of Distributor. Vendor further acknowledges that Product, Distributor Development Materials and any other materials received by Vendor and identified by Distributor as proprietary or confidential are proprietary and trade secrets of Distributor (hereafter "Distributor Proprietary Material").

8.6. Vendor agrees not to disclose Distributor Proprietary Material and to neither do nor permit any act which may in any way jeopardize or be detrimental to the validity of Distributor's patents, copyrights, trade secrets or other rights in Product, Connecting Software, Distributor Development Materials or Distributor Proprietary Material.

8.7. Vendor shall take reasonable precautions to maintain the confidentiality of Distributor Proprietary Material, including taking such steps as Vendor takes to protect its own confidential information.

9. Duration and Termination

9.1. This Agreement shall commence on the date first above written and shall remain in full force and effect for three years. This Agreement may be extended for one-year terms, provided, however, that (a) Distributor meets the targets and milestones for purchases set forth in Schedule E and maintenance objectives set forth in Schedule F and (b) the parties agree in writing to price, target and other terms for each additional one year period.

9.2. This Agreement may also be terminated as follows:

9.2.1. By either party by written notice to the other party if (i) a receiver shall have been appointed over the whole or any substantial part of the assets of the other party, (ii) a petition is filed by the other party initiating any bankruptcy or reorganization proceedings, (iii) such a petition is filed against the other party and such proceeding shall not have been dismissed or stayed with 60 days after such filing or (iv) action is taken to dissolve the other party; and

9.2.2. By either party upon written notice if the other party has breached the terms of this Agreement in any material respect and fails to cure such breach within 30 days after such other party's receipt of written notice of such default.

9.2.3. By Vendor by written notice effective upon receipt if (i) Distributor intends to or is acquired by or merged with a company in competition with Vendor or which produces, markets or distributes software similar to or in competition with Vendor/WORK, or (ii) Distributor acquires rights in or to software similar to or competing with Vendor/WORK.

9.3. Except as provided in the next sentence, the rights granted to Distributor pursuant to Section 2 of this Agreement shall terminate upon any termination of this Agreement. In the event of termination, excluding termination under Sections 9.2.1 and 9.2.2, Vendor agrees Distributor may sell Vendor/WORK during the 60-day period following termination of this Agreement with respect to quotations issued by Distributor to prospective Customers before the termination date.

9.4. Upon termination or expiration of this Agreement for any reason:

9.4.1. Distributor shall deliver to Vendor Vendor/WORK Source Code, Vendor Development Materials and all other Vendor Proprietary Material in Distributor's possession, custody or control, excluding Internal Copies and copies of Vendor/WORK purchased by Distributor prior to termination or expiration. Distributor shall verify to Vendor that Distributor has returned or destroyed all copies of Vendor/WORK Source Code.

9.4.2. Vendor, at its option, may repurchase any or all Vendor/WORK purchased by Distributor prior to termination or expiration and in Distributor's possession at per copy fees not greater than the per copy fees paid by Distributor for such Vendor/WORK. Upon receipt of any Vendor/WORK so repurchased from Distributor, Vendor shall issue an appropriate credit to Distributor's account;

9.4.3. Vendor shall deliver to Distributor Distributor Development Materials and all other Distributor Proprietary Material in Vendor's possession, custody or control, excluding Internal Copies and copies of Product purchased by Vendor prior to termination or expiration;

9.4.4. Distributor shall select one of the following:

9.4.4.1. Distributor may request that Vendor commence to provide some or all of Distributor's Vendor/WORK customers with maintenance services, commencing on the expiration or renewal date of each maintenance contract between Distributor and a customer. Vendor will provide contract documents to such customers and will bill such customers directly at Vendor's current published maintenance prices. Vendor will provide maintenance services for only the Vendor/WORK portion of products maintained by Distributor; or

9.4.4.2. Distributor may continue to provide maintenance services to Distributor's Vendor/WORK customers. If Distributor makes this selection, Distributor will pay to Vendor for the period of 24 months immediately following termination, a fee equal to 12% per year of cumulative purchase prices as of the date of termination of this Agreement. For subsequent periods, Distributor shall pay Vendor for each 12 month period a fee equal to the annual maintenance charges quoted by Vendor at the outset of such 12 month period. All payments under this Section 9.4.4.2. will be due quarterly on the first of each quarter in an amount equal to one quarter of the annual fee.

9.4.4.3. Distributor may only select to transfer maintenance responsibility under Section 9.4.4.1 at the time of termination or annually on the same date thereafter. Vendor must receive notice of intent to transfer this responsibility 90 days prior to each anniversary date. Unless transfer is made within two years of the termination date, Vendor may refuse to accept such transfer;

9.4.5. For a period for six months after the date of termination, Distributor shall make available to Vendor for inspection and copying all books and records of Distributor that pertain to Distributor's performance of and compliance with its obligations, warranties and representations under this Agreement;

9.4.6. Distributor will forthwith cease all use of Trademarks, and will not thereafter use any mark, tradename or slogan which is confusingly similar to any Trademarks;

9.4.7. Each party shall return to the other party all marketing literature and materials provided by such party;

9.4.8. Vendor SHALL NOT BE LIABLE TO Distributor FOR DAMAGES OF ANY KIND, INCLUDING INCIDENTAL OR CONSEQUENTIAL DAMAGES, ON ACCOUNT OF THE TERMINATION OF THIS AGREEMENT FOR ANY REASON; and

9.4.9. Distributor's obligations to pay all amounts due hereunder, as well as Distributor's and Vendor's rights and obligations under Sections 2.2, 2.4 and 8, shall survive termination of this Agreement.

9.5. Upon termination pursuant to Section 9.2.2 for Distributor's breach, the due date of all outstanding invoices to Distributor for Vendor/WORK shall automatically be accelerated so they become due and payable by immediate wire transfer on the effective date of termination, even if longer terms have been provided previously. All orders or portions thereof remaining unshipped as of the effective date of termination shall automatically be canceled.

10. Vendor's Disclaimer of Warranties; Limited Liability

10.1. Vendor warrants that, for a period of 90 days from installation, Vendor/WORK will perform substantially in the manner described in the applicable user manual provided by Vendor.

10.2. OTHER THAN THE LIMITED WARRANTY IN SECTION 10.1, Vendor MAKES NO WARRANTIES OR REPRESENTATIONS AS TO PERFORMANCE OF Vendor/WORK OR AS TO SERVICE TO Distributor OR TO ANY OTHER PERSON. Vendor RESERVES THE RIGHT TO CHANGE THE WARRANTY SET FORTH IN SUCH LIMITED WARRANTY AT ANY TIME, WITHOUT FURTHER NOTICE AND WITHOUT LIABILITY TO Distributor OR ANY OTHER PERSON.

10.3. TO THE EXTENT PERMITTED BY APPLICABLE LAW, ALL IMPLIED WARRANTIES, INCLUDING BUT NOT LIMITED TO IMPLIED WARRANTIES OF MERCHANTABILITY, FITNESS FOR A PADistributorCULAR PURPOSE AND NON-INFRINGEMENT, ARE HEREBY EXCLUDED.

10.4. THE LIABILITY OF Vendor, IF ANY, FOR DAMAGES RELATING TO ANY Vendor/WORK COPIES SHALL BE LIMITED TO THE ACTUAL AMOUNTS PAID BY Distributor FOR SUCH COPIES AND SHALL IN NO EVENT INCLUDE INCIDENTAL OR CONSEQUENTIAL DAMAGES OF ANY KIND.

11. [Reserved]

12. Compliance with Governmental Regulations

The obligation of Vendor to supply Vendor/WORK shall at all times be subject to applicable U.S. export control laws and regulations and to applicable foreign import control laws. The parties will comply with such laws and regulations, including without limitation complying with record keeping and inspection requirements. Distributor understands that Vendor is subject to U.S. government regulations under which export or diversion of Vendor/WORK or other products and software to certain countries is prohibited. Distributor agrees that it will not re-export, outside the U.S., directly or indirectly, any of Vendor's products or technical data relating to such products, without the consent of Vendor and clearance under applicable regulations.

13. Option to Purchase Vendor/WORK

If Distributor first pays Vendor XXX million dollars in aggregate sublicense fees under this Agreement, Distributor shall have an option to purchase a non-transferable, non-exclusive, perpetual license to operate, modify, market, distribute and sublicense Vendor/WORK and Vendor/WORK Source Code, provided that such license shall be limited as follows:

13.1. Distributor shall not use Trademarks or any trademark, trade name or slogan which is confusingly similar to Trademarks in connection with use, marketing, distribution or sublicensing of Vendor/WORK or Vendor/WORK Source Code;

13.2. Distributor shall market, distribute and sublicense Vendor/WORK and Vendor/WORK Source Code only as a part of a package including Connecting Software and Product;

13.3. For three years immediately following purchase of Vendor/WORK Source Code, Distributor shall not market, distribute, disclose or sublicense Vendor/WORK Source Code;

13.4. Software licensed to Vendor from vendors other than Distributor and incorporated in Vendor/WORK shall not be included in purchase of Vendor/WORK Source Code;

13.5. Distributor shall not acquire rights in or to software similar to or competing with Vendor/WORK;

13.6. Distributor shall not be acquired by or merged with a company in competition with Vendor or which produces, markets or distributes software similar to or in competition with Vendor/WORK;

13.7. Distributor shall use its best efforts to prevent access to or disclosure of Vendor/WORK Source Code to Vendor's competitors, including without limitation not selling or licensing to Vendor's competitors at such time when Distributor is entitled to sell or license Vendor/WORK Source Code and taking all appropriate actions and precautions; and

13.8. Distributor shall select one of the following:

13.8.1. Upon exercising this option Distributor shall pay to Vendor a lump sum payment in cash in an amount equal to four times the total sublicense fees and maintenance fees due and payable to Vendor during the 12-month period immediately preceding the date this option is exercised; or

13.8.2. Distributor shall pay to Vendor the following: (i) upon exercising this option Distributor shall pay in cash an amount equal to two times the total sublicense fees and maintenance fees due and payable to Vendor during the 12-month period immediately preceding the date this option is exercised; and (ii) for two years following exercise of this option, Distributor shall pay an amount equal to 5% of revenue from Vendor/WORK due and payable to Distributor, excluding maintenance fees payable to Distributor. For two years following exercise of this option, Distributor shall adhere to the Vendor/WORK sublicense fee guidelines for the period preceding exercise of this option.

14. General

14.1. Distributor and Vendor not Agents

Vendor and Distributor are independent contractors and are not, and shall not represent themselves as, principal and agent, partners or joint venturers. Distributor shall act as a principal on its own behalf and is not authorized to act for or obligate Vendor in any manner. Vendor shall act as a principal on its own behalf and is not authorized to act for or obligate Distributor in any manner.

14.2. Assignability

Neither this Agreement nor any of the licenses or other rights granted under it shall be assignable by Distributor unless the written consent of Vendor shall have first been obtained.

14.3. Non-Competition

14.3.1. The parties agree that maintaining the secrecy of Vendor/WORK and Vendor Proprietary Material is necessary to develop marketable products. In consideration of the licenses granted in Section 2, Distributor agrees that it will not do or enter an agreement similar to this Agreement with any competitor of Vendor listed in Schedule I, Part 1.

14.3.2. The parties agree that exclusive packaging of Vendor/WORK and Product is necessary to develop marketable products. In consideration of the exclusive packaging provided in this Agreement and for so long as Distributor meets the targets and milestones set forth in Schedules E and G, Vendor agrees that it will not enter an agreement similar to this Agreement with any competitor of Distributor listed in Schedule I, Part 2.

14.4. Governing Law

This Agreement shall be governed by and construed in accordance with the laws of the State of Rhode Island.

14.5. Arbitration

All disputes between the parties which may arise in connection with this Agreement shall be finally settled by arbitration conducted in Massachusetts in accordance with the then current rules of the American Arbitration Association. Each party hereto shall be bound by the results of such proceedings.

The provisions of this section shall not preclude the application to any court for injunctive or other equitable relief to prevent the misuse or unauthorized disclosure of proprietary information, or the issuance of any court of such relief.

14.6. Complete Agreement

This Agreement contains the entire agreement of the parties, supersedes any prior oral or written representations or understanding concerning its subject matter, and may not be modified except by a writing executed by both parties.

14.7. Force Majeure

In the event of any delay in performance of this Agreement by reason of any cause arising from or attributable to acts, events, failure of events or other accidents or incidents beyond the reasonable control of the party required to perform, then the party so delayed shall be under no liability for losses or injury suffered by the other party thereby, and this Agreement shall be suspended during such delay. Upon cessation of the cause of the delay, this Agreement shall again become operative, provided that if as a result of such delay a modification of the terms of this Agreement or a cancellation hereof is requested by one party and it is reasonable that such modification or cancellation should be made, this Agreement shall be so modified or cancelled. The provisions of this section shall not in any case be construed to eliminate any obligation of one party for payments to the other party hereunder with respect to any period of delay occasioned by a cause covered by this section, which obligations shall be discharged promptly after such period of delay if not dischargeable during such period, nor shall this section excuse failure of Distributor to meet the purchase targets or milestones set forth in Schedule G or any such future obligations.

14.8. Trials

In the event that a Customer or potential Customer elects to accept Vendor/WORK for trial, Distributor shall obtain prior to delivery of Vendor/WORK, and shall forward to Vendor an executed Trial Letter in the form attached hereto as Schedule J. Upon expiration of the time of the trial, as specified in such Trial Letter, Distributor shall either obtain the return of Vendor/WORK covered thereby or obtain from the Customer a purchase order for Vendor/WORK and an executed Software License Agreement.

14.9. Notice

14.9.1. Vendor shall notify Distributor thirty days prior to Vendor assigning or transferring all its rights in and to Vendor/WORK or selling the company.

14.9.2. Any notices required or permitted to be made by either party to this Agreement shall be made in writing by registered mail, or communicated by cablegram, to the other party at the following addresses:

Vendor Technologies, Inc.	Distributor, Inc.

IN WITNESS WHEREOF, the parties hereto have executed this Agreement under seal by their duly authorized officer or representative as of the date first above written.

Distributor, INC.	Vendor TECHNOLOGIES INC.
By____________________	By____________________
Name (type or print)	Name (type or print)
Title	Title
Date	Date

Appendix B

ABC SYSTEMS, INC.
Address
City, State Zip Code

AGREEMENT FOR ABC SOFTWARE SYSTEMS

Licensee Name: ____________________
Billing Address: ____________________
____
____

ABC Systems, Inc. ("ABC") and Licensee agree that the following terms and conditions will govern each order submitted by Licensee and accepted by ABC for a ABC Software System.

Any order for a ABC Software System requires the submission by Licensee of an executed System Schedule in the form attached hereto.

TERMS AND CONDITIONS

1. Definitions

1.1 "Software System" shall mean a computer software system listed in a System Schedule, comprised of computer programs and routines, related Documentation, and any error corrections, modifications or updates ("Updates") furnished by ABC to Licensee with respect thereto.

1.2 "Documentation" shall mean the printed user manuals and other user documentation furnished to Licensee by ABC for use with ABC Software Systems.

1.3 "Designated Equipment" shall mean the central processing unit(s) designated in a System Schedule.

2. Orders

2.1 Licensee may place an order for Software Systems by submitting an executed System Schedule to ABC. Such order will be effective when accepted by ABC.

3. Grant of License

3.1 Upon ABC's acceptance of Licensee's order for a Software System, ABC will grant to Licensee a nonexclusive, nontransferable license to use such Software System upon the terms and conditions of this Agreement.

3.2 Each license granted under this Agreement authorizes Licensee to use a Software System only on the Designated

Equipment specified in the applicable System Schedule. A separate license is required to permit use of the Software System on any other central processing unit ("CPU") except that, in the event of a malfunction causing the Designated Equipment to become inoperable, Licensee may use the Software System on a back-up CPU on a temporary basis during such malfunction. Licensee may redesignate the CPU for a Software System, or the location of the Designated Equipment (but only to another location within the United States), by providing written notice thereof to ABC.

3.3 Each Software System contains, as an integral component thereof, a database management system known as "Model XXX". ABC's provision of Model XXX to Licensee is subject to a license granted to ABC by DEF Corporation, Address, City, State and Zip Code. This Agreement authorizes Licensee to use and access Model XXX only in conjunction with and by means of the application programs furnished to Licensee by ABC as part of a Software System. Any other access to and use of Model XXX by Licensee requires a separate license from DEF Corporation.

3.4 Licensee may use Software Systems only in connection with the operation and management of Licensee's own business. Licensee is not authorized to grant sublicenses for use of Software Systems or to permit other persons to use Software Systems on a rental, time-sharing, networking or other basis.

4. Charges

4.1 Licensee shall pay ABC the license fees and all other amounts specified in a System Schedule. One-half the amount due ABC shall be due and payable thirty (30) days after receipt of ABC's invoice following delivery of the Software System. The balance remaining due shall be due and payable thirty (30) days after ABC demonstrates, using its standard test data, the successful operation of the Software System.

4.2 Prices are exclusive of all federal, state, municipal and other governmental excise, sales, use, customs, value added, occupational, or other taxes, fees or duties now in force or enacted in the future, including all taxes that are based upon the use, transfer, sale, rental or licensing of computer software. In the event ABC is required at any time to pay any such tax, fee, duty or charge, Licensee will promptly reimburse ABC therefor. In lieu of such payment, Licensee may provide ABC with an exemption certificate or other document acceptable to the taxing authority prior to the assessment of such tax, fee or duty.

5. Delivery, Installation and Training

5.1 ABC shall deliver one copy of each Software System ordered by Licensee to Licensee at the Designated Equipment location specified in the System Schedule. ABC will use reasonable efforts to deliver Software Systems to Licensee on or before any estimated delivery date furnished to Licensee. Estimated delivery dates, however, are approximate only and are not of the essence. ABC shall not be liable for any loss, expense or damages (incidental, consequential or otherwise) if ABC fails to meet an estimated delivery date.

5.2 To the extent specified in a System Schedule, ABC will assist Licensee in the installation of Software Systems on the Designated Equipment; Licensee shall pay all reasonable travel and living expenses incurred by ABC in providing installation assistance to Licensee.

5.3 ABC shall provide licensee with the initial set of Documentation specified in the System Schedule for use with a Software System. Licensee may order additional sets of Documentation at ABC's then current price.

5.4 ABC will conduct such training with respect to the use of Software Systems as is specified in the System Schedule. Licensee shall pay all reasonable travel and living expenses incurred by ABC in providing training to Licensee. Any additional training provided by ABC at Licensee's request will be provided at ABC's then current standard rates.

5.5 Licensee shall be exclusively responsible for the supervision, management and control of its use of a Software System, including, without limitation, selection of the Software System to achieve Licensee's intended results, determining the appropriate use and limitations of the Software System in Licensee's business, and assuring operation of the Software System by qualified, trained personnel.

6. Protection of Proprietary Material

6.1 "Proprietary Material" shall mean (1) Software Systems and any Updates and any portions thereof in any embodiment, and (2) any other information or data, in written, graphic or machine readable form, received by Licensee from ABC and identified by ABC in writing as proprietary or confidential, provided, however, that "Proprietary Material" does not include information which is or becomes available in the public domain (other than through unauthorized disclosure by Licensee).

6.2 Licensee acknowledges that the Proprietary Material is confidential and constitutes a valuable asset of ABC. Licensee shall not use any Proprietary Material for any purpose not specifically authorized in this Agreement.

6.3 Licensee will limit access to Proprietary Material to those employees or consultants whose use of or access thereto is necessary to Licensee's use of Software Systems. Licensee will enter into appropriate agreements with its employees and consultants to prevent the unauthorized use, disclosure or copying of Proprietary Material and shall take all reasonable precautions to protect and maintain the confidentiality of Proprietary Material, including at a minimum, those precautions Licensee employs to protect its own confidential information. Licensee shall not disclose, publish, display or otherwise make available to any person any of the Proprietary Material or copies thereof without ABC's prior written consent. Licensee shall not duplicate, copy or reproduce any of the Proprietary Material, except with the prior written consent of ABC.

6.4 Licensee may make copies of Software Systems only (1) for use on the Designated Equipment and (2) for back-up or archival purposes. Licensee will keep records of the number and location of such copies and make such records available to ABC. Licensee shall not remove any copyright or proprietary rights notice included in any Proprietary Material and shall reproduce all such notices on any copies of any Proprietary Material which Licensee may make.

6.5 Licensee shall not be entitled to obtain source code for Software Systems furnished under this Agreement, except that ABC shall provide Licensee with the source code for the application component (i.e., not including Model XXX) of the Software System. Licensee shall not disassemble or decompile any object code version of a Software System or otherwise attempt to generate, use or modify any Software System source code.

6.6 ABC and its licensors shall retain all title, copyright and other proprietary rights in and to all Proprietary Material furnished by ABC to Licensee and all copies thereof made by Licensee.

6.7 Licensee's obligations under this Section 6 shall survive any termination or expiration of this Agreement.

7. Warranties; Limitations

7.1 ABC warrants that, during the one (1) year period following delivery of a Software System, the Software System will conform in all material respects to the specifications contained in the Documentation initially furnished to Licensee for use with the Software System. ABC's sole responsibility under this warranty shall be to correct or replace that portion of the Software System which fails to conform to said warranty. ABC will have no liability under the foregoing warranty if (1) Licensee modifies the Software System without ABC's prior written consent, (2) Licensee fails to give ABC written notice of the claimed breach of warranty within said one (1) year warranty period or (3) the failure to conform is caused in whole or in part by persons other than ABC or by products, equipment or computer programs not furnished by ABC.

7.2 THE EXPRESS WARRANTIES SET FORTH IN THIS SECTION 7 ARE THE ONLY WARRANTIES GIVEN BY ABC WITH RESPECT TO SOFTWARE SYSTEMS FURNISHED TO LICENSEE; ABC MAKES NO OTHER WARRANTIES, EXPRESS,

IMPLIED OR ARISING BY CUSTOM OR TRADE USAGE, AND SPECIFICALLY MAKES NO WARRANTY OF MERCHANTABILITY OR OF FITNESS FOR ANY PARTICULAR PURPOSE. ABC'S EXPRESS WARRANTIES SHALL NOT BE ENLARGED, DIMINISHED OR AFFECTED BY, AND NO OBLIGATION OR LIABILITY SHALL ARISE OUT OF, ABC'S RENDERING OF TECHNICAL OR OTHER ADVICE OR SERVICE IN CONNECTION WITH SOFTWARE SYSTEMS.

7.3 Except as is set forth in Section 8 of this Agreement, ABC's liability in contract, tort or otherwise arising out of or in connection with a Software System or this Agreement shall not exceed the license fee paid to ABC by Licensee with respect to said Software System. IN NO EVENT SHALL ABC BE LIABLE FOR SPECIAL, INCIDENTAL, CONSEQUENTIAL OR TORT DAMAGES, INCLUDING ANY DAMAGES RESULTING FROM LOSS OF USE, LOSS OF DATA, LOSS OF PROFITS, OR LOSS OF BUSINESS ARISING OUT OF OR IN CONNECTION WITH THE PERFORMANCE OF SOFTWARE SYSTEMS OR ABC'S PERFORMANCE OF SERVICES OR OF ANY OTHER OBLIGATIONS RELATING TO SOFTWARE SYSTEMS, EVEN IF ABC HAS BEEN ADVISED OF THE POSSIBILITY OF SUCH DAMAGES. Except with respect to damages caused by ABC's negligence, Licensee shall indemnify ABC and hold it harmless from any loss, claim or damage to any person arising out of Licensee's use of Software Systems.

8. <u>Patent and Copyright Indemnification</u>

8.1 ABC shall defend Licensee or, at ABC's option, settle, any claim that a Software System infringes any United States patent or copyright or any trade secret, and shall indemnify Licensee against all costs, damages and expenses finally awarded against Licensee which result from any such claim, provided that Licensee notifies ABC promptly in writing of any such claim, gives ABC full and complete authority, information and assistance to defend such claim and gives ABC sole control of the defense of any such claim and all negotiations for its compromise or settlement. Should a Software System or any part thereof become, or in ABC's opinion be likely to become, the subject of a claim of infringement, ABC shall have the right, at ABC's option and expense, either to procure for Licensee the right to continue using it, or to replace or modify it so that it becomes noninfringing (provided that such modification or replacement does not materially degrade its quality or performance) or, after reasonable attempts have been made with respect to the foregoing alternatives, to refund the license fee paid to ABC by Licensee, less a reasonable allowance for use.

8.2 ABC shall have no liability or obligation with respect to any infringement claim based upon the combination of Software Systems with other products not furnished by ABC or any addition to or modification of Software Systems made by any person other than ABC. ABC will have no obligation for any costs incurred by Licensee without ABC's prior written authorization. This Section states ABC's entire obligation and liability for infringement by Software Systems or the use thereof.

9. Term; Termination

9.1 This Agreement shall become effective on the date on which it is accepted by ABC at ABC's principal place of business in Boston, Massachusetts and shall remain in effect unless terminated as provided herein. The grant of license for a Software System shall take effect on the date on which the applicable System Schedule is accepted by ABC in Boston, Massachusetts and shall remain in effect unless terminated as provided herein or for the term, if any, set forth in the System Schedule.

9.2 If Licensee shall fail to perform or shall be in breach of any of its obligations hereunder and shall have failed or been unable to remedy said failure or breach within thirty (30) days after receipt of written notice from ABC with respect thereto, ABC may terminate this Agreement, or any license granted hereunder, by giving written notice of termination to Licensee.

9.3 Within one month after any termination or expiration of any license granted hereunder, Licensee (a) shall deliver to ABC all Proprietary Material received from ABC or made in connection with such license, including copies thereof, and (b) shall destroy or render unusable all other such Proprietary Material and copies thereof, including information and data relating to the Software System stored in any storage facility, which for any reason cannot be delivered to ABC. In addition, an authorized employee of Licensee shall certify in writing to ABC that all such Proprietary Material has been delivered to ABC, destroyed or rendered unusable and that use of the terminated Software System and any portion thereof has been discontinued.

10. General Provisions

10.1 This Agreement sets forth the entire agreement of the parties with respect to the subject matter hereof, and supersedes all prior oral and written agreements and understandings relating thereto. No representation, condition, understanding, statement of intention or agreement of any kind, oral or written, shall be binding upon the parties unless set forth or specifically incorporated herein. No waiver, alteration, modification, or cancellation of any of the provisions of this Agreement shall be binding unless made in writing and signed by the parties. The failure of either party at any time or times to require performance of any provision hereof shall in no manner affect the right at a later time to enforce such provision. No remedy referred to in this Agreement is intended to be exclusive, but each shall be cumulative and in addition to any other remedy referred to herein or otherwise available at law or in equity. Any provision of Licensee's order which is in any way inconsistent with or in addition to the terms and conditions of this Agreement shall not be binding upon ABC unless ABC specifically accepts any such provision in writing.

10.2 Neither ABC nor Licensee shall be liable for any delays in the performance of any of its obligations hereunder due to causes beyond its reasonable control, including, but not limited to, fire, strike, war, riots, acts of any civil or military authority, acts of God, judicial action, unavailability or shortages of materials or equipment, failures or delays in delivery of vendors and suppliers or delays in transportation.

10.3 All written notices to be given in connection with this Agreement shall be sufficient if sent by certified or registered mail, postage prepaid, addressed to the party entitled or required to receive such notice at the addresses specified on the first page hereof.

10.4 In the event that one or more of the provisions contained in this Agreement shall for any reason be held invalid, illegal or unenforceable in any respect, such invalidity, illegality or unenforceability shall not affect any other provisions contained in this Agreement.

10.5 This Agreement shall be subject to and interpreted in accordance with the substantive law of The Commonwealth of Massachusetts.

10.6 This Agreement shall be binding upon and inure to benefit of the parties and their respective successors, assigns and legal representatives, provided, however, that the rights, duties and privileges of Licensee hereunder may not be assigned, sublicensed or otherwise transferred by it, in whole or in part, without the prior written consent of ABC.

ABC AND LICENSEE ACKNOWLEDGE THAT THEY HAVE EACH READ THIS AGREEMENT AND AGREE TO ALL TERMS AND CONDITIONS STATED HEREIN.

Licensee

By:______________________
(authorized signature)

Name:____________________
(please type or print)

Title:___________________

Date:____________________

Accepted by
ABC Systems, Inc.

By:______________________

Title:___________________

Date:____________________

Mr. EDWARDS. Thank you, Mr. Hemnes.

I will now recognize the gentleman from West Virginia, Mr. Staggers.

Mr. STAGGERS. Mr. Chairman, I would ask unanimous consent that the subcommittee permit the meeting to be covered, in whole or in part, by television broadcast, radio broadcast, and/or still photography, pursuant to Rule 5 of the Committee Rules.

Mr. EDWARDS. Without objection, so ordered.

The next member of the panel to testify is George Hahn, of Hahn and Hessen, representing the National Bankruptcy Conference. Mr. Hahn.

Mr. HAHN. Good morning, Mr. Chairman, and members of the Committee. I am here on behalf of the National Bankruptcy Conference, of which I am a member and chairman of its Committee on Executory Contracts.

In the early fall we were approached by an industry coalition asking our assistance in connection with a bill which they had proposed, which was then pending in the Senate, having been introduced by Senator DeConcini, S. 1626. Our National Bankruptcy Conference reviewed that bill and found it to be obscure and difficult to fathom. We met with some of the representatives of that group and realized, however, that they had underlying their concerns a very real problem that was created by the *Lubrizol* decision.

We recognized the potential chilling effects of the stripping away of the intellectual property rights from a licensee by a bankruptcy leading to a rejection of the license agreement. We recognized that this not only impinged upon the domestic licensing mechanism, but it also had international implications since licensing today is in the international arena and is understood by industries throughout the world and used by them. We saw these serious consequences.

In addition to that, the Conference realized that the *Lubrizol* decision was probably mistaken. In its interpretation of what the consequences are that flow from a rejection, the rejection of a licensing agreement or any other executory contract should not lead to the total unraveling of executed, completed performances. The whole essence of rejection is that it relieves the debtor of future specific performance. It relieves him of having to go forward with these burdens that he has yet to perform, but it should not take away or retrieve completed transactions or completed transfers. The *Lubrizol* court appeared to have lost that distinction in reaching the decision that it did.

We also felt that, if there was going to be legislation in this area, the National Bankruptcy Conference could contribute meaningfully to the quality of that legislation. For these reasons, we were authorized in our respective committees of the Conference to meet with this group to work on a new bill. In the course of the winter, the Conference, as well as representatives of the Business Bankruptcy Committee of the American Bar Association, worked with the industry group and hammered out a draft bill which evolved finally into H.R. 4657. That bill was approved by the National Bankruptcy Conference in its earlier form, but substantively the same, in its March meeting, and was similarly approved by the

Business Bankruptcy Committee of the ABA when it had its midyear meeting in March as well.

Those approvals authorized representatives of both those groups to testify and to go forward on behalf of the bill which we have here, subject to fine-tuning and only one caveat: that we hope that in the legislative history it would be made clear that in addressing intellectual property licenses there was no implication or inference intended that this legislation would affect the treatment of any other type of executory contract.

We believe that the bill as now proposed is desirable for two reasons. First, it balances very carefully the respective interests of the two parties. The debtor is freed from future burdens of performance and is assured of the cash flow coming from the royalty payments, despite the rejection. On the other hand, the licensee is able to retain the extant intellectual property and can therefore rely on his ability to use it when he makes substantial investments at the outset of the relationship. He can also retain it on an exclusive basis.

We believe this is consistent intellectually with the concept of rejection, and that it is consistent with the requirements and purposes of section 365.

Thank you.

[The statement of George A. Hahn follows:]

NATIONAL BANKRUPTCY CONFERENCE
(A voluntary organization composed of persons interested in the improvement of the Bankruptcy Code and its administration.)

June 1, 1988

Subcommittee on Monopolies and
Commerical Law
B-353 Rayburn House Office Building
Washington, D.C. 20515

Statement of George A. Hahn, Esq., on behalf of the National Bankruptcy Conference concerning H.R. 4567

I am a member of the National Bankruptcy Conference (the "Conference") and chairman of its Committee on Stays and Executory Contracts. I appear on behalf of the Conference to testify in favor of the enactment of H.R. 4567.

Background of the Legislation

In the fall of 1987 a coalition of representatives from American industry and trade associations calling themselves the "Bankruptcy Licensor Coalition", approached the Conference in regard to Senate Bill 1626, entitled "Intellectual Property Bankruptcy Protection Act of 1987", introduced by Senator DeConcini. The bill sought to protect the interests of licensees of intellectual property by overturning parts of the decision in In re Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043 (4th Cir. 1985) cert. denied sub nom, Lubrizol

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<u>Enterprises Inc. v. Canfield,</u> 106 S. Ct. 1285 (1986) - the so-called "Lubrizol" case. The Coalition hoped to obtain the support of the Conference for this legislation as well as the help of the Conference in trying to reconcile the Coalition's objectives with the requirements of bankruptcy law.

The Conference viewed S.1626 with skepticism, finding that it was unclear and 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.

Despite these infirmities, the Conference responded favorably to the Coalition's request for assistance, for the following reasons: (a) The Conference recognized the genuineness of the Coalition's concern, inasmuch as the <u>Lubrizol</u> decision had created a general chilling effect upon the system of licensing rights in intellectual property, with potentially serious adverse consequences for start-up companies in the "high tech" industries; (b) the Conference had strong reservations as to the correctness of the <u>Lubrizol</u> decision as it interpreted the consequences which properly should flow from rejection of an executory contract; and (c) if proposed amendments to 11 U.S.C. § 365 were to be considered, the Conference felt a responsibility to see that they were grounded upon sound bankruptcy law concepts.

During the winter of 1987 representatives of the Conference (including the writer) and representatives of the Business Bankruptcy Committee of the American Bar Association ("ABA") participated in a series of meetings with Coalition representatives. From these discussions and the work of a drafting group formed by them a new, "draft bill" emerged. The draft bill is the precursor of H.R. 4567. Your legislative counsel, by "fine tuning" and altering the format of the draft bill, succeeded in achieving greater precision and clarity. But in substance, the draft bill and H.R. 4567 are virtually the same.

At its mid-year meeting the Conference authorized its representatives to support enactment of the draft bill, subject to fine tuning. At its March meeting the Business Bankruptcy Committee of the ABA adopted a resolution supporting in concept the draft bill, subject to fine tuning and subject to the further stipulation that its legislative history should contain an express statement that the proposed amendment is not intended to affect the status of executory contracts other than licenses of intellectual property. The Conference is of the same view. The enactment of this bill should not permit inferences that Congress thereby intended a particular result affecting the nondebtor party in any transaction falling outside the scope of the legislation. Such a mode of statutory construction has been employed by courts with misleading results.[1]

Principal Effects of H.R. 4567

The bill, to an extent, parallels the existing provisions of 11 U.S.C. § 365(h)(1) relating to rejection of an unexpired lease of real property, perhaps in order to suggest that the bill treats licensees of intellectual property rights no more specially than holders of other unique rights have been treated, such as real property lessees. Under subsection (h) the lessee may treat the lease as terminated by the rejection, or in the alternative, may elect to remain in possession of the leasehold for the balance of the lease term and for any renewal or extension thereof. Similarly, under H.R. 4567, the licensee of intellectual property may treat the contract as terminated by such rejection or in the alternative, may elect to retain its rights to such intellectual property for the duration of the contract and any period for which such contract may be extended (§ (n)(1)(B)). But the remaining provisions of subsection (h) and the proposed bill are directly opposite. Under subsection (h)(2) the lessee of real property who remains in possession may offset against the rent, damages caused by the debtor's nonperformance of any obligations under the lease,

[1] See for example, Lubrizol Enterprises Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043 at 1048 ("...no comparable special treatment is provided for technology licensees"...)

but otherwise has no damage claim. In contrast, the licensee under H.R. 4567 waives any right of setoff and must make all payments due under the contract for the duration of the contract and any period for which the licensee extends it. However, the licensee will retain a general claim for damages from rejection, as a breach of contract under § 365(g).

H.R. 4567 contains a series of checks and balances of the competing interests of the parties. The essential purpose of rejection of executory contracts is to relieve the debtor of the burden of future specific performance. Consistent with that purpose, H.R. 4567 does not impose material future performances upon the debtor following rejection. The rejection power, by the same token, is not an avoidance power intended to unravel executed transactions. H.R. 4567 therefore overrules the Lubrizol decision in permitting the licensee to retain his rights to intellectual property conveyed prior to the commencement of the case, despite rejection. This restores the rejection power to its reasonable limits in keeping with the essential purpose of rejection, while it preserves the system of licensing of intellectual property, with all of its flexibility and multiple uses.

In exchange for his ability to retain rights to intellectual property, the licensee is required to make all payments due under the contract without right of setoff ((n)(2)(B) and (C)). This assures the debtor-licensor of the cash flow of royalty payments under the contract, which may be essential to the debtor's reorganization. Thus, through rejection the debtor is relieved of future specific performances and their burdens and still retains enjoyment of the cash flow from the contract, free from setoff. What he can no longer count on is a windfall from recapture and resale of rights previously conveyed (if the licensee elects to retain them and make the required contract payments).

If the licensee elects to retain his rights to the intellectual property, it is intended that such rights shall be as provided in the contract ("the trustee shall allow the licensee to exercise such rights." - (n)(2)(A)). If the contract grants the licensee an exclusive use, such exclusivity would be preserved to the licensee. The licensee therefore can invest in research and marketing of intellectual property in reliance upon his ability to retain an exclusive right to such use, if he so contracted.[2]

Conference Support of H.R. 4567

Rejection under § 365 should not avoid or retrieve rights which the non-bankrupt has already received under the contract. The purpose of § 365 is to solve the problems of exercising or requiring future specific performance of the bankrupt. In re

[2]This has the effect of overruling the decision of In re Select-A-Seat Corporation, 625 F.2d 290 (9th Cir. 1980), decided under the former Bankruptcy Act, which held that upon rejection, the debtor-licensor was relieved of any obligations of exclusive dealing.

Executive Technology Data Systems, 79 Bankr. 276 (Bankr. E.D. Mich. 1987). Section 365 addresses only future performance obligations of the parties. It does not have any impact upon the executed portions of a contract. Executive Technology Data Systems, supra; See Leasing Service Corp. v. First Tennessee Bank National Assoc., 826 F.2d 434, 437 (6th Cir. 1987). Rejection of an executory contract is not the equivalent of rescission. Murphy v. C & W Limited Corp. (In re Murphy), 694 F.2d 172, 174 (8th Cir. 1982). Based upon these principles, the Lubrizol Court wrongly permitted rejection to strip Lubrizol of rights to the use of technology which the debtor, prior to the bankruptcy, had conveyed to it. H.R. 4567 will correct the injury to technology licensing threatened by the Lubrizol decision.

The perceived problems for start-up companies who use licensing to raise seed money would not, in itself, necessarily persuade the Conference to support new legislation. The Conference has often opposed legislation which it perceived as in the nature of special interest legislation. Here, the circumstance are otherwise. This proposed bill will correct a significant distortion of bankruptcy law resulting from a decision which erroneously treats contract rejection as the equivalent of a rescission.

H.R. 4567 is the product of a close collaboration between industry members, their counsel and bankruptcy counsel from the

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Conference and the ABA's Business Bankruptcy Committee, who together worked to reconcile the needs of technology licensees with those of debtor-licensors undergoing reorganization. The Conference believes that the proposed legislation would bring about an acceptable balancing of their respective interests consistent with correct bankruptcy principles.

Sincerely,

George A. Hahn

GAH/pk

Mr. EDWARDS. Thank you very much, Mr. Hahn.

The last member of the panel to testify is Harry F. Manbeck of General Electric Company, testifying on behalf of Intellectual Property Owners, Inc. Mr. Manbeck.

Mr. MANBECK. Thank you, Mr. Chairman. I feel a bit abashed in this company. I am not a bankruptcy lawyer. I am but a poor patent lawyer, struggling to maintain a minor position in this area.

IPO, the Intellectual Property Owners, is an organization consisting of many companies and people who are interested in intellectual property and the licensing of intellectual property, and they have been concerned, particularly at the board level, in the effect of the *Lubrizol* decision, in that licensing is very important to us, both what we call "in" licensing—in other words, licenses where our companies may be acquiring rights—and also licenses where we are granting rights to others, "out" licensing.

As you may know, licensing is a big, big business in this country. The latest Commerce Department statistics, I am told, show there is $8.1 billion of licensing income obtained from foreign sources for this country, with only a minor offset, in effect, of money paid out to foreign licensors.

Now, speaking from the position which I hold, I really have not had an awful lot of experience with the plight of the small licensee, or licensor in the bankruptcy situation. On the other hand, it is very dangerous in the case of some corporation putting a lot of money into a new plant, based on a license which will come from the contractor putting up the plant, the fellow who has the technology. This is not uncommon. I mean, plants costing hundreds of millions of dollars go up, which depend upon a license, where the plant owner will ultimately pay royalties on the through-put to the licensor.

If the licensor should go into bankruptcy and the trustee or the bankrupt as debtor in possession be able to disavow that license, the plant owner would be placed in a disastrous position. He could do nothing. He's got a plant that is, say, seven-eighths ready to go and no license to make it go. So I give you that just as one example as to why we are very concerned about the long-term effect of the *Lubrizol* decision.

Now, it has been mentioned here about confidentiality and that the bill might allow the destruction of confidentiality to the detriment of the bankrupt licensor. I submit to you that that is not a real world concern. A licensee who has paid for confidential information has no other interest but to maintain that information on a confidential basis. At this point, that's his stock in trade. He doesn't want that confidential information spread to the world. That means his competitors can just come in and compete with him for nothing. So the bill allows for the preservation of confidential information and I think the licensee would be the first one to come to the bankruptcy judge and say let's maintain it as confidential.

To show you that this concern is not just a corporate concern in our organization, I spoke at a meeting of the Practicing Law Institute in February, and this subject was a subject of major concern at that seminar. Those of us on the podium tried to contribute; people on the floor got up and talked about it; there must have been about a 20-minute discussion about this problem and how you could solve it under existing law. The answer is that nobody came up with a decent way of solving it on an overall basis on existing law. So it is our feeling that this legislation is really badly needed. We think it strikes a good balance between the needs and rights, of the licensee and those of the licensor, and we certainly hope that it will be passed.

Now, with some diffidence, I would like to suggest one thing, however, and that is that in the definition of intellectual property our organization would very much like to see an express reference made to patents and copyrights, because they and trade secrets, we think, are the most important things that this bill protects. Having lived through some other legislation where we thought we had the words in right, and some very clever lawyers twisted them in the end, I think it would be to the Nation's advantage to bring those specifics in without detracting from the general definition which is there today.

Thank you, sir.

[The statement of Harry F. Manbeck follows:]

IPO INTELLECTUAL PROPERTY OWNERS, INC.

STATEMENT OF HARRY F. MANBECK

GENERAL ELECTRIC COMPANY

ON BEHALF OF

INTELLECTUAL PROPERTY OWNERS, INC.

ON H.R. 4657

BANKRUPT LICENSOR LEGISLATION

BEFORE THE

SUBCOMMITTEE ON MONOPOLIES AND COMMERCIAL LAW

OF THE

COMMITTEE ON THE JUDICIARY

HOUSE OF REPRESENTATIVES

June 3, 1988
9:30 A.M.

1255 TWENTY-THIRD STREET N.W. SUITE 850, WASHINGTON DC 20037 (202) 466-2396
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Mr. Chairman and members of the Subcommittee:

I welcome this opportunity to comment on the proposed bankrupt licensor legislation.

I am appearing here on behalf of Intellectual Property Owners, Inc. (IPO). I am a member of IPO's Board of Directors and chief intellectual property counsel for the General Electric Company.

IPO is an association of large companies, small businesses, universities and individuals who own patents, trademarks, copyrights, trade secrets, and similar rights. The association's members have extensive experience with technology licensing, both as licensors and as licensees. IPO is a member of the Bankrupt Licensor Coalition, a group of associations and companies which support H.R. 4657 and a substantively similar Senate bill.

Intellectual Property Licensing

Effective legal protection for intellectual property has become a topic of increasing concern to U.S. industry and government policymakers. Intellectual property is now widely recognized as being important to the U.S. economy.

Licensing contracts, both domestic and international, help achieve efficient use of intellectual property. Licensing enables a larger number of firms to have access to intellectual property. Licensing also allows the creator or owner of intellectual property to maximize its income from the property.

By way of example, recent trade statistics illustrate the value of intellectual property rights in international transactions. According to the Commerce Department's Survey of Current Business, royalties and fees received by U.S. industry from international licensing transactions are now $8.1 billion a year, more than 6 times the amount U.S.industry is paying to foreign firms in royalties and fees. The government does not collect data on licensing payments within the United States, but domestic licensing also is very substantial.

The creator of new technology often is not in the best position to commercialize the technology. Other firms may have superior manufacturing capability or a better distribution network. This is particularly true when the owner of the intellectual property is a small business. Or the owner may not be in the business of manufacturing at all, as in the case of a university.

Licensing contracts give the owner flexibility to license different firms to use the property in different geographical areas or different types of products, or to use only one feature of the property, such as the technology defined by one of several claims in a patent. Licensing can be for period of time shorter than the life of a patent or copyright. Licensing also can provide income to the owner to finance further development or to finance testing needed for government approval to market the technology.

Licensing is important to every type of industry which relies on intellectual property, including chemicals, computers and software, electronics, entertainment, pharmaceuticals, and many others. Since licensing promotes efficient use of technology, licensing can help improve the competitiveness of U.S. industry.

A licensing agreement, of course, requires a willing licensor and a willing licensee. Parties enter licensing agreements only when they are reasonably certain that they will benefit from the arrangement.

The Lubrizol Ruling

We strongly support H.R. 4657, which in essence would overrule the interpretation of the bankruptcy code by the Fourth Circuit Court of Appeals in Lubrizol Enterprises v. Richmond Metal Finishers, 756 F.2d 1043, 226 USPQ 961, (1985), cert denied 475 U.S. 1057 (1986). The Lubrizol court permitted Richmond Metal Finishers, the licensor and bankrupt debtor in possession, to reject its technology licensing agreement with Lubrizol, the licensee, on the ground that the bankruptcy code permits a bankrupt licensor to reject an executory contract if rejection would be advantageous to the bankrupt.

While the Lubrizol case is not necessarily the law in other circuits, it creates great uncertainty about the ability of licensees to retain their rights when the licensor becomes involved in a bankruptcy case. Licensees' lawyers are being forced to spend a great deal of time and effort attempting to devise strategies to prevent their clients' being deprived of use of the licensed technology in the event of licensor bankruptcy. These strategies, which may or may not be effective, include drafting contracts that have almost no continuing obligations and therefore might be ruled not executory, and/or drafting escrow agreements, and so forth.

Of course, a party who desires to use intellectual property can buy it outright and thereby gain protection from adverse bankruptcy consequences, since the intellectual property no longer belongs to the seller or its bankruptcy estate. On the other hand, a new enterprise may be very reluctant to sell the intellectual property outright, because the intellectual property may be the enterprise's most important asset.

Moreover, a prospective licensee may have to pay more than it can afford to buy intellectual property outright. For instance, the licensee may wish to exploit the intellectual property in only a single field of use, and be unwilling or unable to pay a higher price to obtain the right for all fields of use.

Allowing a trustee in bankruptcy to disavow a technology license agreement in hopes of getting a better deal elsewhere is grossly unfair to the licensee. Intellectual property almost by definition is <u>unique</u> property. A licensee of intellectual property who is deprived of its right to the property usually cannot go elsewhere and license equivalent technology from a different licensor.

A policy that deprives licensees of their rights or causes uncertainty discourages licensing. Businesses are unlikely to risk investing in technology if the party offering the license might face financial difficulty. Many software companies, biotechnology companies and other smaller enterprises are in weak financial condition but own valuable technology they would like to license. It is not in the public interest to discourage agreements with such parties.

In addition, if bankrupt licensors or their trustees can take away the intellectual property rights of licensees, bankrupt licensors have the ability to hold licensees hostage in order to obtain a new agreement. By the time of bankruptcy, the bargaining positions of parties may have changed from when the licensing agreement was made. For example, if licensed software already has been installed in a licensee's facilities but the licensor through bankruptcy law is able to cut short the original license, the licensor probably can extract a new agreement from the licensee at a much higher price.

Benefits of H.R. 4657

The central provision in H.R. 4657 is the paragraph (proposed bankruptcy code section 365(n)(1)(B)) permitting the licensee under an executory contract for intellectual property rights to retain its rights for the duration of the contract if the trustee rejects the contact.

In addition to benefitting licensees, we believe this provision will help licensors by bringing certainty to licensing law, making it easier for owners of intellectual property rights to find willing licensees.

By permitting the licensee to elect to retain its rights to utilize the licensed intellectual property but denying a right of specific performance of the licensor's obligations under the license contract, the bill strikes a balance between the rights of the parties. It may not be possible to require a trustee in bankruptcy to perform obligations such as providing maintenance services or updating software. The bill recognizes this with the provision stating that the

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licensee does not retain its right under applicable non-bankruptcy law to specific performance of the contract.

It is critically important, however, for the licensee to be allowed to retain the full extent of its rights to utilize the licensed intellectual property, including the right to continue to be the exclusive licensee if the agreement entered into is exclusive. We understand the language "the trustee shall allow the licensee to exercise such rights" in paragraph 365(n)(2)(A) is intended, inter alia, to preserve the licensee's right to an exclusive license. The trustee should not be able to reject a provision of the license prohibiting further licensing of the technology by the licensor while otherwise leaving the pre-petition licensing agreement in place, as was done in one case. Fenix Cattle Co. v. Silver (In re Select-A-Seat Corp.), 625 F.2d 290 (9th Cir. 1980).

Licenses frequently obligate the parties to protect the confidentiality of trade secrets or other information in their possession. We understand that either party to a license where the licensee retains its rights after rejection of the license contract by the trustee would be able to ask the bankruptcy court to protect confidential information pursuant to section 107(b) of the bankruptcy code.

As we understand H.R. 4657, it gives the licensee rights that are about the same as those enjoyed by lessees of real property under bankruptcy code section 365(h). Although the bill does not give an intellectual property licensee the right of setoff enjoyed by real property lessees, the bill compensates for this by giving the intellectual property licensee a right to recover for breach of its contract. The licensee would be entitled to submit a claim for any damages it sustains from the trustee's rejection of the contract. This would be by virtue of section 365(g) which makes rejection of an executory contract of the debtor a breach of the contract except in the case of real property leases and sales which are expressly excluded from section 365(g).

Giving the right to claim for breach of contract in lieu of allowing setoff seems to be a reasonable trade. Startup enterprises that have licensed technology may have a special need to receive an uninterrupted stream of royalty payments, undiminished by any setoff. Otherwise such enterprises may have no chance to reorganize under the bankruptcy code. On the other hand, the licensee should be able to recover for any damages it suffers to the extent such damages may be allowable in the bankruptcy proceeding.

Subsections 365(n)(3) and (n)(4) call for the trustee on written request of the licensee to provide to the licensee any intellectual property held by the trustee and to not interfere with the rights of the licensee, including the right to obtain intellectual property "from another entity". We understand the reference to another entity to address problems connected with arrangements such as escrow agreements.

The same paragraphs also refer to providing "embodiments" of the intellectual property to the licensee. We understand an embodiment to be the tangible product in which the intellectual property is embodied, such as a disc, phonorecord, etc. Applicable non-bankruptcy law may afford separate rights in tangible products embodying intellectual property.

We believe the definition of "intellectual property" proposed for section 101 of the bankruptcy code covers four of the five main types of rights protected under modern intellectual property laws: trade secrets, patents, copyrights and semi-conductor chip mask works.

The fifth type, trademarks, is not covered in the bill's definition. Trademark licensors have a responsibility for controlling the quality of the products or services sold by the licensee under the trademark. We realize it is thought that a trustee in bankruptcy cannot be expected to fulfill this kind of responsibility. But we note that a trademark licensee could be severely damaged by the loss of its trademark license in a situation when it is in no way at fault and where the debtor may be reorganized rather than liquidated. We hope a way can be found to address that situation.

We believe the language used in section 1(a) of H.R. 4657 to define intellectual property could be clearer or more explicit as to what legal rights are covered. We believe the language is intended to cover patents, copyrights, including copyright registrations, and plant variety certificates, but these legal rights are not specifically called out. We would prefer language which does this, because it would leave no room for argument that these rights are not covered. The Omnibus Trade and Competitiveness Act of 1988, H.R. 3, makes specific reference to patents, copyrights, etc. in its sections dealing with trade negotiating objectives and the amendments to section 337 of the Tariff Act of 1930, and we suggest that such reference is appropriate in H.R. 4657.

* * *

In closing, we submit that H.R. 4657 provides the solution to a simple but urgent problem affecting bankruptcy and intellectual property law. We are aware of some other issues relating to bankruptcy and intellectual property that have been raised by various bar associations and interested parties--for example, legislation relating to security interests in patents -- but we know of no other issue besides the bankrupt licensor issue on which there is such an immediate need for legislation and an apparently broad consensus in the intellectual property community on the kind of legislation needed.

We compliment Representative Edwards on introducing H.R. 4657 and Chairman Rodino and the Subcommittee on holding this hearing. We believe the bill will provide certainty in the law and promote intellectual property licensing, and we urge its early enactment.

Mr. EDWARDS. Thank you very much, Mr. Manbeck.

We will be operating under the five-minute rule. The gentleman from New York, Mr. Fish, is recognized.

Mr. FISH. Thank you, Mr. Chairman.

Mr. Hahn, what is your response to the argument that problems involving the treatment in bankruptcy of intellectual property licenses should be dealt with in the context of a comprehensive reexamination of Bankruptcy Code section 365, which we have already amended on various occasions, rather than carving an exception to the general statutory scheme for intellectual property licenses?

Mr. HAHN. That very thought did occur to the National Bankruptcy Conference when we were initially approached, because the Conference had already then decided to embark on a major review of the entire operation of section 365, recognizing that 15 years had elapsed since the celebrated law review article of Professor Vern Countryman dealing with executory contracts, and a vast amount of law has developed in the interim.

However, we recognized that that overhaul, that study, would probably take several years to complete within the Conference. And then, if the Conference evolved a concept and an approach and a solution that it was confident of, it would have to go out and convince various other groups today in the bankruptcy field and come forward with a piece of proposed legislation. We felt it was unfair and unreasonable to expect or to request the licensing industry to wait for a couple of years. It was too problematical, too contingent, too indefinite, to really be an answer to their immediate problem.

Therefore, we tried to find something that was narrower and that would meet the problem today, and would not do violence to the basic structure of section 365. We think this bill has achieved that because it is a very delicate balance between the needs and the requirements of both parties to the contract and there is precedent for it because it is similar to the treatment that Congress has accorded to a lessee in possession of real property, who cannot be disturbed by a rejection or ousted of his possession because of the nature of a completed conveyance that the law attributes to a lease. Yet, there had to be some tinkering with that situation.

We have modeled that and put the licensee, if you will, in the position of one in possession of intellectual property rights to the extent that they existed at the time of the filing. We felt that that was a conservative solution.

Some of the other solutions that my colleague has suggested, like resorting to the section 1113 approach, is a useful idea to be considered in the future, but not immediately. That type of solution is one that is new and untried. We have had very limited experience with it in the field of collective bargaining. We haven't used it extensively elsewhere. It is not really a system of assumption and rejection; it is really a system of consensual modification of agreements and it requires a system of intensive negotiation between the parties. I don't know whether it would work in the particular area that we're talking about. It is one of those things that is under study that a year or two from now we will have a better answer for than we have at the present time.

What we are doing here is something that is narrow and is intellectually consistent with the rejection power and which addresses the problem in a narrow way.

Mr. FISH. Thank you, Mr. Hahn. I'll get back to you. In your reply you got into another area that I wanted to get the views of several panel members on, so I will ask this question of Mr. Burger and Mr. Manbeck.

What is your assessment of possible legislation requiring courts to consider the potential adverse consequences on licensees as part of the process of reviewing a proposed rejection? As you know, this has been suggested as an alternative to this legislation.

Mr. BURGER. Congressman, we have problems with that, in that perhaps, narrowly, we're looking at the beginning, at where you start out in this process, which is the product or intellectual property that comes from some place—usually, as I said before, in our industry, a couple of young enterprising individuals who have developed it. We need to sit down and look at an overall system where both sides have some assurance of what will happen over the years. To tell us that we don't have that assurance, that some place in the middle of this process of getting to market and developing a product marketplace the product could disappear from us, that our whole investment could go down the tube, so to speak, because a judge, in that individual judge's wisdom, decides, for reasons that have nothing to do with the bargaining between the parties, to reject the contract, because that judge thinks the particular licensee's interest won't be as damaged as the bankrupt's interest.

We are very much, as Mr. Hahn said, like the situation with real property. This is something that is more than just a car somebody is renting to somebody else. It's a piece of intellectual property. Often an entire line of business will be developed along with a tremendous amount of investment placed upon it. We can't really enter into that without some assurance of how it will be treated later.

Mr. FISH. Thank you.

Mr. Manbeck, did you have a comment?

Mr. MANBECK. I think the problem, sir, is that each piece of intellectual property is unique, almost by its definition. It can't be copyrighted, you can't get a patent on it, unless it is unique. A licensor may have invested very considerable sums in his implementation of this unique piece of property. If it is taken away from him, he is left in a position that he just can't go forward with his program. Working back from that, if that is to be the case, then he is very likely to be reluctant to put sums into a program where the licensor may be a little shaky at the time the program is begun. So I think anything which does not assure the licensee of his right to a continuing license—assuming he pays the required royalties himself—is counterproductive to licensing in general and, therefore, counterproductive to the best use of assets to further develop the American industrial system.

Mr. FISH. Thank you.

If the Chair would indulge me for one further question.

Mr. Hemnes, could you explain the impact you think this legislation that we have before us today will have on unsecured creditors who are not licensees of intellectual property?

Mr. HEMNES. It will have an adverse impact on unsecured creditors of that kind, Mr. Congressman. The nub of the legislation is that when there is an existing contract that includes the license of intellectual property, the licensee may continue to exercise its right under that license, regardless of how burdensome that may be on the estate of the debtor.

It is possible to imagine cases in which even an existing nonexclusive license of intellectual property can be quite burdensome on the estate of a debtor. One example I have given in my testimony is a distributorship agreement which, if it is granted on the wrong terms or to the wrong person, or otherwise is a bad idea, can really make it very difficult for the licensor to market its product. If the licensor can't get out from under that kind of an agreement, its unsecured creditors are likely to be hurt.

Mr. FISH. Returning to you, Mr. Hahn——

Mr. HAHN. I wonder if I might have an opportunity to reply to that question.

Mr. FISH. Let me ask you a question and see if that gets you into it.

Mr. Hemnes has acknowledged—and I quote—"As applied to a simple license of the type involved in *Lubrizol,* H.R. 4657 is not a bad piece of legislation." He points out, however, that "Unfortunately, simple licenses of the type involved in *Lubrizol* are the exception rather than the rule." My question is, do you believe H.R. 4657 will lead to appropriate results in cases involving complicated commercial transactions that include licenses of intellectual property?

Mr. HAHN. It is my belief that it will not unduly complicate those transactions. The bill does not leave future burdens on the licensor. The licensor is relieved of his future burdens of specific performance. All that he cannot do is unravel that which has been a completed transaction in order to take it and resell it to someone else for a higher price. He shouldn't be allowed to do that anyway. The rejection power was never intended to accomplish that. All that rejection was intended to accomplish was to create an abandonment of future burdens. That's what the concept is all about. It is not an avoidance power, it is not a rescission of the transaction. Therefore, no matter how complicated the transaction may be, I do not see how it imposes future serious burdens on the licensor that he, in fairness and in equity, should be relieved of through the exercise of the power of rejection. That is why I disagree with what Mr. Hemnes has said a moment ago.

Mr. FISH. Thank you.

Mr. EDWARDS. The gentleman from West Virginia, Mr. Staggers.

Mr. STAGGERS. Thank you, Mr. Chairman.

Mr. Hemnes has agreed that something needs to be done. I think from listening to him that he's indicated that maybe the pendulum has gone too far to the other side in favor of the licensor.

Would the other three panelists respond to that, to his concern, that there may be a better alternative than the bill we have before us?

Mr. BURGER. Congressman Staggers, let me first say that I am not a bankruptcy expert and I have to rely on Ms. Shea-Stonum and Mr. Hahn. When we started out from a very simplistic intellectual property industry viewpoint, we had a very simple bill that seemed to me to just go out and solve the problem. But we thought we needed to consult with experts. We sat down with the experts, and very articulately Mr. Hahn explained to us that we really went too far and we were doing violence to some basic bankruptcy concepts. So we sat down over a period of several months and negotiated very hard, and both Ms. Shea-Stonum and Mr. Hahn worked many hours creating a conservative bill.

I really take issue with the fact that there is something else that could be more conservative. Again, I would defer to Ms. Shea-Stonum to tell us her view of Mr. Hemnes' solution. But I wanted to make one other point, which is—and I can only speak for our industry and for the many licensing agreements that I have negotiated and others our company have been involved with—that they are very simple and straightforward, that I don't——

Mr. STAGGERS. I don't doubt that you have worked very hard on this. I have worked very hard on legislation, and the legislation I have worked on hardly ever gets through without some sort of changes.

Mr. BURGER. Oh, no, I appreciate that, sir. But let me defer to Ms. Shea-Stonum because she is our expert on the bankruptcy laws.

Ms. SHEA-STONUM. Thank you very much.

Mr. Staggers, the starting point of Mr. Hemnes' analysis is, I think, in correct. He assumes that the law on executory contracts still requires that before a contract can be rejected it must be established to be burdensome. If that were still the law as applied by most courts, I do not believe we would be here today.

What the *Lubrizol* case and other cases which have followed it makes quite clear is the inquiry is no longer focused on burden. It is focused on "benefit to the estate". The point that Mr. Hahn made just a few moments ago, that bankrupts should not be permitted to use the bankruptcy laws to sell again that which they sold in good faith before the bankruptcy, is what brings us here today.

What we are trying to do—again, it's a matter of starting points. Mr. Hemnes, in all good faith, starts looking at the bankruptcy system itself. Of course, we are here seeking an amendment to the Bankruptcy Code. But the problem that we are addressing is the overhang which the bankruptcy laws are creating for the entire licensing system. In the licensing system, 99½ percent of the licenses will never see the light or dark of a bankruptcy court. But this problem is very much impacting the way in which deals are being structured, and some deals are not being done today. Some deals are being done in a very contorted fashion to try and deal with this problem.

Most importantly, what's happening is that in the deals that are being done, the licensor's future ability to deal with other people is now being limited. We submit that the balance that needs to be addressed is to go back and assure that the licensing system is not in any way imperiled and that this product of Yankee ingenuity continues to be viable, both in our domestic marketplace and in the international marketplace.

Mr. STAGGERS. Should a confidentiality protection provision be added to the bill?

Mr. HAHN. I'm sorry, I didn't understand your question.

Mr. STAGGERS. Should a confidentiality protection provision be added to the bill?

Mr. HAHN. I don't see the necessity of that. As Mr. Hemnes himself pointed out, section 107 makes it possible for either party to enforce confidentiality by applying to the court for an order. He says there is something terribly wrong about having to be put to the burden of going to court in order to enforce the confidentiality. There is nothing that Congress can do in legislation other than to create a remedy enforceable by a court. That remedy is already in the statute. There's no point in duplicating it.

Mr. HEMNES. If I could briefly respond to that comment, I am sensitive to Mr. Manbeck's argument that a licensee who obtains trade secrets from a licensor also has an interest to protect those trade secrets. However, having written probably hundreds of these agreements, I can say that every one of them includes confidentiality obligations imposed on the licensee which, to me, reflects a perception on the part of a licensor that you need to have more than the licensee's interest in your agreement. You need to have an enforceable contract. Trade secret law, in fact, requires one to have enforceable agreements against persons who are in possession of your trade secrets for the trade secret to exist at all.

My concern about H.R. 4657 is that, following rejection of a license, one would no longer have an enforceable confidentiality agreement and that would, in itself, jeopardize the trade secret.

Mr. BURGER. Congressman, could I allow Ms. Shea-Stonum to make a comment on your question?

Ms. SHEA-STONUM. What is interesting is how we come full circle. In the first draft of this concept, we had incorporated specific provisions with respect to the maintenance of confidentiality, which is very much a concern I think for both sides, in trade secrets and in other areas as well.

The National Bankruptcy Conference participants pointed out to us that section 107 was in the law and one of the things which the National Bankruptcy Conference feels very strongly about is not having things said over and over again in the Code.

Mr. Hemnes talks about the burden on the debtor, on the rejecting debtor having to move under section 107. It strikes us that if the rejecting debtor is going to go to court on its application or its motion to reject under section 365, at that time it can also seek the protections of section 107.

We, on the other hand, have been quite concerned about the licensee. The licensee will have to go into court under section 107 and seek protections. But I think it's a question of somebody has to take an action. The mechanism is already in the Code. We are satisfied that section 107 creates an appropriate mechanism for dealing with confidentiality issues for both parties. We do not think that the Code should be unduly cluttered.

Mr. STAGGERS. Mr. Chairman, I have no further questions.

Mr. EDWARDS. Thank you, Mr. Staggers.

We have opposition here to the bill, but not the problem, by Mr. Hemnes, who obviously is an expert in this field. You do find that we have a serious problem; is that correct?

Mr. HEMNES. Absolutely, Mr. Chairman.

Mr. EDWARDS. And you do think that the bill could be amended so that you could approve of it?

Mr. HEMNES. I do. As I say, I have suggested a couple of things. I don't mean to be wedded to the ideas that I have proposed, but I think there are ways to achieve the protection that licensees need when they enter into these transactions without at the same time creating the over-breadth and inequities that I think this bill may cause.

Mr. EDWARDS. You suggest that the bill 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* did not affect, and then you propose an alternative that you say would cause far less harm to fundamental bankruptcy policies. You suggest, I guess, that the most equitable solution would be to require the court to consider the impact of rejection on the licensees. That is the heart of your suggestion, is that correct?

Mr. HEMNES. Yes. If I may respond in a little greater length, I think that is the most equitable solution. On the other hand, I think that the point that has been made today by a number of the other witnesses is that when licensees enter into these transactions, some may feel that they have to have certainty that their rights cannot be cut off by the licensor, no matter what happens.

Although I am concerned that they may be asking for more assurance than you can realistically get in this world when somebody is bankrupt, I think that it is possible to go a little bit further than the balancing-of-the-equity sort of approach of section 1113 in giving that assurance. That is why I have suggested the identification of a protected form of right that one could incorporate into these agreements in appropriate circumstances.

Mr. EDWARDS. Well, that means that in many, many cases you would just have a new argument, isn't that correct, and a certain amount of uncertainty would be there because you don't know what the judge would say.

Mr. HEMNES. As I say, I think in bankruptcy proceedings certainty is a will-o'-the-wisp, of sorts. I think even under the proposed bill there isn't going to be certainty as to what is the scope of the licensee's rights.

To give you an example, one of the agreements that I submitted as an exhibit to my testimony includes an option to acquire a fully paid up, nonexclusive license following a period of royalty payments. I don't know if the current bill would cover such an option or not. So there would be uncertainty, no matter what you do.

Mr. EDWARDS. Thank you.

I would like to ask Mr. Hahn what kind of an effect on reorganization the bill as it is would have.

Mr. HAHN. We believe that it will further reorganization rather than hinder it. It's not fair perhaps to single out individual examples because every example is sui generis. But in the *Lubrizol* case, the Lubrizol company was stripped of all of its rights, to enable the licensor to go out and peddle those rights somewhere else. Nevertheless, the licensor ended up in a Chapter 7 liquidation soon thereafter. So it was all to no avail.

On the other hand, if we had had a bill and a statute like what we're proposing, then perhaps a major company like Lubrizol would have continued to make royalty payments despite the rejection, would have retained its essential rights at that time, and there would have been a cash flow and a basis on which a reorganization of the licensor could have been accomplished to the benefit of all unsecured creditors.

We believe that that type of solution is furthered by this statute, not hindered by it, and therefore, this is constructive and, on the whole, a beneficial solution.

I would like to say that the balancing test that Mr. Hemnes is suggesting, the Conference also considered that and found that it would not work. The problem is that in many of these cases the record before the court is too sparse, there's too little in the record to balance. A balancing test works fine when you're dealing with a collective bargaining agreement with an enormous number of—you have almost a constitution of conduct by the parties that is continuing. But in these types of transactions, frequently there is insufficient evidence to do an effective balancing. I doubt that a balancing test would change the result in a great majority of the cases.

Mr. Hemnes himself acknowledges that as he retreats from that solution to another solution. His other solution, as I said, is the type of solution that should be considered, but only in the context of a major overhaul of the entire section, which will take a couple of years. The problem here today is too immediate and I don't think it can wait for that.

Mr. EDWARDS. Thank you.

I have one question before we complete this round, and before I yield to Mr. Fish again.

This bill contains a definition of intellectual property which includes an invention, process, design, or plant variety. This subject has come up before in our discussions this morning. Should there be an addition to this definition to limit it to only a patent invention?

Mr. MANBECK. If the question is directed to me, sir, I don't think it should be limited to just a patented invention. What I would suggest is broader—because a trade secret may include an invention, which we're trying to protect. But I think the definition should make it clear that the word "invention" is not exclusive of patents. In other words, it is inventions, including patents and patent applications thereon which are to be covered—I've forgotten the words, but works of authorships, including copyrights thereon—should be mentioned too to make sure that these very important specifics are covered by the bill.

Our fear—and this is not my fear alone; there are others sitting in this room who have the same concern—is that unless these Government-granted, very important rights are mentioned, sooner or later some lawyer is going to say Congress deliberately didn't mention them and, therefore, they're not included. I really think this is a valid concern.

Mr. EDWARDS. Does anybody else want to comment on that?

Mr. HEMNES. Mr. Chairman, if I could just briefly say, if that change were made in the bill, I think the provisions that require the licensor to turn over the intellectual property would have to be amended, because obviously you wouldn't want to require somebody to assign a copyright or to assign the ownership of the patent. I take it that that's not what Mr. Manbeck is——

Mr. MANBECK. No, I don't think the bill requires that. The bill is talking about embodiments. I think what is really meant there is the disk on which the copyrighted computer program appears, that he may have to turn over the disk. But it certainly does not obligate him to turn over the ownership of the copyright or the patent. About the worst one could argue is that he would have to turn over a patent copy, but that means nothing since anybody can go to the Patent Office and buy one for, I think, 75 cents these days. So I don't think that's a real concern.

Mr. EDWARDS. Thank you.

Mr. Fish, do you have some more questions?

Mr. FISH. Yes. Thank you, Mr. Chairman.

Ms. Shea-Stonum, I understand you were involved in the *Lubrizol* case. My question to you is, to what extent is it possible to ameliorate the problems created by that decision through changes in contractual provisions in future licensing contracts rather than through legislation?

Ms. SHEA-STONUM. That's a question that a lot of people have been asking since they first read the *Lubrizol* decision. A lot of clever lawyers are trying to create structures which avoid the *Lubrizol* problem, and some are succeeding narrowly. The problem is that the narrow solutions for the so-called *Lubrizol* problem are really the problem in and of themselves.

What happens is that the first person who goes to negotiate with the owner of intellectual property will say "I've read the *Lubrizol* decision and I want an assignment." I am aware of a number of instances where the negotiations break down right then and there because the person that Mr. Burger has described, the person who has slaved for several years developing something, it's like a mother with her child in the delivery room. They do not want to part with the ownership of that. It's a very emotional topic.

There are structures evolving such as "we will take an assignment and license you back." That works with the first party, perhaps. But the problem is the impact that this has on field of use licensing. In our country and throughout the world, one of the advantages of licensing is the ability for the same technology to be developed in numerous different fields simultaneously. If you have only one party owning the rights, insisting on owning the rights, the development rights, you're going to have, we submit, in many instances not as full and complete a development of those ideas as ought to occur. That is the fundamental problem that we're here today asking this committee to address. As Mr. Burger put very eloquently, we're trying to bring the Bankruptcy Code in sync with a system that is understood internationally, and we are trying not to force people into structures which are uneconomic and not useful to the economy overall.

Mr. FISH. Thank you very much.

Mr. Hemnes, does a debtor-licensor of intellectual property get a windfall if he can terminate the licensee's interest in intellectual property rights already conveyed, leaving the licensee with only a claim for damages, and then sell those same rights to another person?

Mr. HEMNES. It depends on what one means by windfall in the context of bankruptcy proceedings, and also the circumstances of the case. There is case law, for example, that if you agree to sell your house for $100,000, you haven't passed papers and the money hasn't been paid, and at the time of the bankruptcy filing it's worth $200,000, you can reject the contract and sell it for the $200,000 and make the extra $100,000 available to your other creditors. You can argue that that is a windfall, but it exists already in the Bankruptcy Code. So if it is a windfall, it is not an unusual windfall.

But I would agree with the general principle, that yes, indeed, it's also possible for a licensor to use the threat of rejection to, in effect, extort a higher license fee from the licensee. That can be very damaging. There's no doubt whatever about that. That's part of the problem created by *Lubrizol.*

Mr. FISH. Mr. Burger and Mr. Manbeck, would you care to respond to this question? Are there any differences in the way licensors and licensees view the efficacy of this legislation, and if so, could you explain it?

Mr. MANBECK. Well, Mr. Fish, I think about the only comment I can make is that, in the Intellectual Property Owners organization, we are at all times both licensors and licensees. We grant licenses and we take licenses. I don't know of a single dissenting vote, at least on the board of directors of IPO, to this legislation.

When you are trying to help in the patent affairs of a major corporation, for example, you always have to be sensitive that at one time you're going to be on one side of this equation and at another time you're going to be on the other side of the equation——

Mr. EDWARDS. Would the gentleman will yield at that point?

Mr. FISH. Of course.

Mr. EDWARDS. I believe the witness is talking about corporations that don't have to worry too much about bankruptcy.

Mr. MANBECK. You may have a licensor who may go under. Who, 15 years ago, would have thought Manville or Texaco would go under. The world is a little different than it used to be. Perhaps the fear is not as great with many large corporations, but the fact remains it is possible and it is a very serious thing, particularly if you have put money into plant facilities and development in reliance on a license and then it could be stripped away from you and you can do nothing about it. That's our problem.

Mr. BURGER. Congressman, perhaps you could explain the question a little more to me, because I guess I'm looking at this fairly simplistically. Prior to *Lubrizol,* we thought we understood what we were doing when we entered into license agreements, and both sides seemed to benefit very well from licensing. I mean, it's our way of doing business, essentially. All of a sudden *Lubrizol* cropped up and we viewed that from both sides—as we also license technology—viewed it from both sides and thought oh, here's a roadblock, and all we think we're asking for is to return things to the way we always thought we were doing business. Perhaps I'm missing something in your question, sir.

Mr. FISH. No, I don't think so, and you're responding pretty much the same way Mr. Manbeck did, which is what we anticipated.

Mr. Hahn, if I could just end with you, do you foresee any substantial likelihood that the Federal courts will correct problems resulting from the *Lubrizol* decision, by recognizing the needs of licensees of intellectual property in future cases, if we fail to take any action on legislation addressing this problem?

Mr. HAHN. Well, that is, I guess, an "iffy" question. First of all, these cases don't come up every single day. It may be some time before another high court actually tackles the very issues that occurred in *Lubrizol*.

At the moment, however, I would say that the prospects are not favorable to this being worked out by the courts. In the first instance, we have a business judgment test which is extensively applied by Federal bankruptcy courts throughout the United States today, which says that the business judgment of the licensor debtor should be left virtually unimpeded. If it's beneficial to the reorganization from his perspective, if it is beneficial to creditors, he need not consider, and the court need not consider, what the effect would be on the licensee. Therefore, the licensee's problems don't even enter into the equation as that balancing test has been propounded by many, many courts. That is the majority view. There is a minority view, which is growing, but it may take several years before a more equitable balancing test evolves. So that's your first problem.

The next problem that you have is for Federal bankruptcy courts to understand better than they seem to now what the consequences of rejection should be, and that rejection is not to be used as an avoidance power to unravel completed transactions. We are seeing some cases now that are coming down in other areas where there's a growing awareness of that. But I would say it could be several years before the problem is worked out through the court system, if then. Therefore, I think there is a need for immediate legislation.

Mr. FISH. Thank you.

Thank you, Mr. Chairman. I think this has been a very good hearing.

Mr. EDWARDS. Thank you, Mr. Fish.

We welcome the gentleman from New Jersey, Mr. Hughes.

Mr. HUGHES. Thank you, Mr. Chairman. I don't have any questions of the panel.

Mr. EDWARDS. Mr. Hahn, you mentioned that the courts might eventually work out a balancing doctrine. Do you have one in mind that would be legislatively feasible?

Mr. HAHN. Well, not really. I think there are a minority of courts who have said that a bankruptcy court is a court of equity and, as such, it must take into consideration not only what is beneficial to the creditors in the reorganization process, but the impact upon the other party, the nondebtor party, to the contract. If the injury to the nondebtor party is totally disproportionate to any likely benefit that the debtor licensor or the debtor seeking to reject is likely to gain by the rejection, then the court ought not to allow the rejection.

I don't see our legislating such a balancing test, first because I think ultimately the courts will adopt that. 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.

However, that balancing test, in and of itself, even if it is adopted, is not going to solve the problem that we have before us, because that is only the threshold issue. If you come to the conclusion that rejection should be permitted, then you are faced with the question of what are the consequences of rejection. That is really the issue here, what are the consequences of the rejection, if it is allowed. If the consequence is to strip away the license rights of the licensee, or if that is a likely or probable consequence, then you have the chilling effect on the entire licensing mechanism which impacts domestically and on the international scene as well. It works to the disadvantage of both parties because, if you dry up the goose that lays the golden egg, if there is no flow investment, the licensor will not be able to develop and promote his invention or creation and it's to the detriment of both parties and ultimately to the society itself.

Mr. EDWARDS. Thank you.

Counsel?

Mr. GOLDBERGER. Thank you, Mr. Chairman.

Mr. Hahn and Mr. Hemnes, are the license agreements so different in the impact of their rejection upon the licensee from all other executory contracts to which section 365 applies so as to warrant this legislation? Should we carve a special exception for these types of agreements, or should we just try to revisit section 365 entirely to try to deal with some of these special situations that Congress has dealt with in the past couple of years?

Mr. HAHN. Well, that gets back to the question at the beginning, and that is whether or not to await a complete study of the entire field of executory contracts, and then try to rework and overhaul the whole field. That would be a study that will require a couple of years of intensive work to develop something that is internally consistent and which will yield widespread support and approval as a legislative solution. I don't think anyone is quite ready to tackle that on a very broad scale at this point in time.

We have a system of exceptions today; that has been the course that Congress has pursued. Congress has recognized and dealt with special situations. I mentioned lessees in possession, but there are purchasers in possession, there are collective bargaining agreements, there are shopping centers and a whole slew of these situations.

Mr. GOLDBERGER. Is it the position of the NBC that Congress should continue to create exceptions as they arise, or that Congress should also be looking at some other overall solution to 365 instead of exceptions?

Mr. HAHN. It's the position of the Conference that, in the long run, the better solution is to have a total cohesive section rather than going on and on, creating individual exceptions. That is not, in our judgment, the best way to develop good bankruptcy legislation. We have frequently testified in opposition to special interest legislation, or what we conceived it to be.

The reason why we did not take that position here, and why we took the opposite position, is first a perceived judgment on our part that there is a very real and chilling effect to the way we do licensing business in the United States and in the international arena, and secondly, that the *Lubrizol* case has misconstrued the consequences of rejection and, therefore, it is unsatisfactory law. So we were faced with a dilemma: do we wait until we have a complete overhaul, or do we address the issue in the immediate term? Our judgment was, for the business reasons, it was probably better to address it in the immediate term, but keeping in mind, however, that in the long run we want to revamp the entire section and address the problems of the entire section.

Finally, I want to return to the point I made at the outset, and that is that there should be in this legislative history a caveat that makes it clear that no negative inferences are to be drawn or should be drawn by courts that, because the Congress has legislated in a particular way a licensing agreement, those other agreements that are not within the parameters of the legislation are to be dealt with in any particular way. We hope the legislation will be neutral and will not lead to that type of misleading statutory construction, which in the past has proved to be a problem.

Mr. GOLDBERGER. Thank you, Mr. Hahn.

Mr. Hemnes, do you have a comment on that?

Mr. HEMNES. Yes, very briefly.

I begin by saying that I agree with almost everything that Mr. Hahn said. I think that it would be advisable to take a long, hard look at section 365. On the other hand, I think that doing that would take a long, hard time, and there is an acute problem created by *Lubrizol* that needs to be addressed now.

My complaint, though, is that the proposed bill, H.R. 4657, would create, in my view, a loophole in section 365 that's really a mile wide and would in some respects constitute a substantial revision of section 365 when that really wasn't intended by the proponents of the legislation.

Mr. GOLDBERGER. Thank you, Mr. Hemnes.

Mr. EDWARDS. Following along that line, Mr. Hemnes, and other witnesses, you're testifying that there would be some serious consequences if this bill is enacted into law. What would your predictions be? What would the effect be on businesses?

Mr. HEMNES. To begin with, I'm not saying the sky is going to fall if this is enacted into law. I think that it would be substantially more difficult to reorganize some debtors who are licensors of intellectual property. I believe that there could be a chilling effect, in addition, on the ability of persons who license intellectual property to obtain financing for their businesses.

As I testified before, one of the effects of the legislation will be to provide a lower measure of return for unsecured creditors. I think that an open question under the legislation is what it's impact would be on secured creditors. In this respect, there is a difference between the bill that's pending in the Senate and the one that's pending here in the House. I think the House bill is better. I realized, when I was referring to something Mr. Manbeck had said before, I was thinking of the Senate bill. That one requires a turnover of certain intellectual property. Well, if that were the case, it would, in my view, create, in effect, a super priority as to that intellectual property that could arguably take precedence even over a perfected security interest. I think that that problem is less acute in the House bill, but I nevertheless think that it would have some effect on the ability of licensors to raise money. Not a lot, but some.

Mr. EDWARDS. Mr. Hughes?

Mr. HUGHES. I have just a couple of short follow-up questions from the testimony elicited by counsel with regard to section 365.

I wonder, Mr. Hahn, is there any consensus within the Conference as to how one would craft provisions dealing with executory contracts?

Mr. HAHN. You mean, Mr. Hughes, as to how to revise it or overhaul it?

Mr. HUGHES. How would you revise section 365 to deal with, generically, executory contracts?

Mr. HAHN. At this moment in time, there really is not. There are a lot of ideas floating around. A lot of people feel that the issues have to be reviewed with an open mind. The way the Conference intends to approach it is basically the way Professor Countryman did it 15 years ago, which is to go back and to review every single problem area, read every case in that area, and out of those solutions try to evolve new concepts, or change the old concepts in ways that will make them more efficient and more workable. That type of thing is a very slow process.

Professor Countryman described it once in his article by saying he was creating an elephant by chipping away everything that was not an elephant. It's a very slow, cumulative effect. I don't believe at this moment in time I could say there is a coherent view within the Conference. Some of the ideas that Mr. Hemnes mentioned are ideas that people find intriguing, like consensual modifications in which the court, under the threat of a rejection, forces the parties to get together and, within a very short time period, come up with a solution to their problems.

We think that this legislation, in a way, will accomplish that, because it will change the leverage. By changing the leverage, the parties will get together and probably negotiate their problems with only occasional interference by the court. To that extent, we think this is a constructive approach. Chapter 11 is intended to be as consensual as it can be, and I think by making the playing field more level, giving the licensee the opportunity to hold on to the rights he has already acquired, provided he is prepared to pay for them and going forward, creates that level playing field which will encourage negotiation between the parties.

But back to your central question, I don't believe at the moment I could honestly say that the Conference has an answer.

Mr. HUGHES. We made some special exceptions, some special rules for residential property, shopping centers, in the '84 provisions. Was there something unique about those particular executory contracts that demanded special treatment, in your judgment?

Mr. HAHN. Well, this speaker didn't think so. I testified in opposition on behalf of the Conference to many of those special changes. We felt that they were in the nature of special interest legislation designed to create safe harbors for particular vested interests. Again, I think in this situation there is far more justification than there was in those, because we're dealing with a system of licensing that is very basic to some of our important start-up research and development companies that keep us at the cutting edge of technology in so many fields on an international basis. I think there is more of a concern here than there should be over a shopping center.

Mr. HUGHES. So you feel there are compelling reasons to treat intellectual property licenses differently than other property, for instance, and for that reason you would support a special exception?

Mr. HAHN. Well, yes, and I don't say it's so special, because what we're doing here, as I said, is very analogous to what—there is precedent for it as far back as the Chandler Act of 1938. Congress has recognized that a lessee who is in possession of real property had certain unique rights in that property and he could not be ousted by a rejection. We're using that as an analogy and a precedent for giving the licensee of intellectual property a certain measure of protection to the extent that those rights are already in existence at the commencement of the case.

Mr. HUGHES. I gather from your testimony that you really do not support a balancing test, so I presume you would not agree with the decision of the 9th Circuit decision in 1982, *In re Huang,* which used the flexible test?

Mr. HAHN. No, I do support a balancing test, and I do think the flexible balancing test is the preferable test and is the more reasonable test. It is shocking to me that a court of equity could actually apply a business judgment test in which it says "we don't even have to consider that we're destroying the business of the nondebtor party and it's none of our concern; all we're concerned about is, is this good for the debtor." To me, that's a very skewed standard to go by. Unfortunately, the Supreme Court of the United States, in the *Bildisco* case, seems to have helped that position along.

Mr. HUGHES. I misunderstood you. So you do support the——

Mr. HAHN. I do support the standard. All I'm saying is that that balancing test, number one, is not prevalent throughout the United States, and two, if they did follow it, it would not solve this problem, because in many of those cases there isn't enough in the record to balance. I don't know that the result would be different.

Take, for example, the *Lubrizol* case. I don't know that the court would have necessarily come out with a different result if it had used the correct balance test, which it did not, because Lubrizol wasn't paying any royalties. Lubrizol hadn't even started up using the process in that case. A court could well balance the evidence and come out with the conclusion that rejection should go forward.

Where *Lubrizol* went wrong was, having decided on rejection, it carried the rejection power too far and it stripped away the rights of Lubrizol. Therefore, I say the balancing test, even though it could be improved and should be improved, will not meet the problem.

Mr. HUGHES. Do any of the other panel members have anything else to add?

Mr. BURGER. Just one thing, Congressman. One of the reasons we're here is that we're dealing with very unique property. By virtue of what we think is some very good law in the intellectual property area, there are essentially limited monopolies, patents in particular, in terms of ideas, and copyrights in terms of the expression of those ideas. The problem for the licensee is it's not replaceable. You can't go out and find very readily, in most cases—certainly in terms of patents—you can't go out and find something that is fungible, something that you can replace it with. So it really is a special circumstance in our mind. That's why we're where we are.

Mr. HUGHES. Thank you, Mr. Chairman.

Mr. EDWARDS. I understand Mr. Hyde, the gentleman from Illinois, does not have any questions. We welcome him.

Counsel, do you have any more questions?

Mr. GOLDBERGER. Yes, Mr. Chairman, just a few more.

To clarify a point for the record, under the legislation the licensee has the right to elect to retain its rights as such rights existed immediately before the case commenced. In a contract situation, the rights of one party are often the obligation of another—in this case, the debtor.

If the licensee retains its rights, is it your understanding that the debtor would have no corresponding obligations other than the mere obligation to allow the licensee to continue to use the technology? In other words, if the agreement provided, for example, for the debtor to provide training to a licensee, the licensee might make the argument under the legislation that it has a right to training. Yet it appears that the intent is not to burden the licensor.

How should we, if we need to at all, deal with that situation?

Ms. SHEA-STONUM. When we started down this road, the first suggestion that was made by the intellectual property folks around the table was let's just make these agreements nonrejectable. We said well, that was a solution which would probably not wash because in many instances the debtor in possession, and certainly in most instances, the trustee, is in no position to perform affirmative obligations. So what we have worked with legislative counsel and staff to come to is a position where, if the license is rejected, what is being rejected are the affirmative obligations, obligations, for instance, to train.

There are a couple of affirmative obligations that are specifically carved out of that. The obligation to turn over material so that the licensee can do the things which the licensor was supposed to do, but is no longer doing because of the breach. Also, as we understand the intent of Mr. Edwards, the trustee and debtor in possession are not relieved of the negative obligation not to license other people in the situation where the pre-petition license was an exclusive license, but that the watershed, if you will, is affirmative obligations versus negative obligations. Negative obligations, the debtor in possession or the trustee must abide affirmative obligations. If they have chosen to reject, they are relieved of those affirmative obligations, except for those explicitly identified in sections 3 and 4 of the proposed bill.

Mr. GOLDBERGER. Before the others comment, is the bill sufficiently clear on that point now? Should the bill be clarified, or is it something that should be dealt with instead in the legislative history?

Ms. SHEA-STONUM. We would very much like to work with you a little bit on the legislative language with respect to exclusivity. I think we would like to work with you, if you will permit us, to clarify in the legislative history the watershed of affirmative and negative obligations.

Mr. GOLDBERGER. Are there any comments from any of the other panelists on that point?

Mr. HEMNES. If I could follow up on that, I think that your question puts a finger on one of the really basic problems with the legislation. If you take a case where the licensor has an obligation to train the licensee's personnel, and the contract is rejected, I will guarantee you that what will happen in every bankruptcy proceeding is the following: the licensee will elect to retain its rights, it won't pay the amounts owing, and it will say to the licensor, "so sue me." The licensor will bring an action and the licensee will defend on the ground that the licensor is materially in default of its obligations under the contract and therefore the licensee is excused of its obligation to pay. I think that's probably a good defense.

It gets back to the basic point that in a complicated transaction, one in which the obligations on the licensee and licensor go far beyond a mere right to use and a mere obligation to pay, you really can't just drag those obligations out of the body of the transaction and keep them alive in an equitable way without keeping the rest of the agreement alive as well. So I think it is a serious problem in the current legislation.

Mr. GOLDBERGER. Mr. Hahn, and then Mr. Manbeck.

Mr. HAHN. I don't see that at all. The statute makes very clear that if the licensee elects to retain those rights, then he must make the payments called for under the contract. If he fails to make those payments, on whatever excuse or pretext he elects to raise, the bankruptcy court will enforce that right. A licensor debtor in possession will go into court and insist on having those payments made, or the licensee will lose his rights to retain that intellectual property. I don't think that's going to happen.

We have today, under the statute, lessees who stay in possession of real property and can't be ousted if those leases are rejected. When they're rejected, the lessor is relieved of performing various services to the premises. Those cases haven't presented any problem. If the lessee stays in possession, if he makes that election, he pays the rent. He has to pay the rent. He is entitled to certain offsets under the statute, but beyond that, he has to perform his responsibilities and he has done it, and the bankruptcy court is there to see that they're enforced. I think that would happen here, too.

Mr. GOLDBERGER. Do you believe, Mr. Hahn, that if the licensee breaches a nonpayment obligation of the license, the debtor would have a sufficient remedy?

Mr. HAHN. The debtor has the remedies that are accorded by the statute, to insist that if the licensee chooses not to treat the rejection as a termination of the relationship but instead chooses to retain and to use the intellectual property, that he must continue making his payments. And not only must he make the payments, he may not deduct by way of set-off and he cannot try to back door the deduction by coming up with an administration claim. The statute says he has none that arises out of the relationship. So he is forced to make those payments, and the bankruptcy court is there to enforce that right on behalf of the estate.

Mr. GOLDBERGER. Let me hold a follow-up question to that until Mr. Manbeck has a chance to give his point of view.

Mr. MANBECK. Well, I was just going to say, from my limited perspective of the bankruptcy area, it seems to me that the bill clearly says that the licensee must make its payments. As to this thought that there might be some more work that has to be done, I think the bill clearly relieves the licensor from that. He has to turn over that which exists at the time the proceeding starts, but he doesn't have to continue to supply technical help and all of that sort of thing. If that places the contract in a position where it's not satisfactory to the licensee, the licensee can then himself reject. So it seems to me it strikes a very nice balance the way it now stands.

Mr. GOLDBERGER. Thank you.

The legislation also says that if the licensee retains its rights, the licensee has to continue making payments. It doesn't specifically address what else the licensee has to do, though. Suppose the licensee improperly takes apart a licensed program to see how it works. Does the debtor/licensor have a remedy?

Mr. HAHN. You're correct, that there isn't anything in the bill that expressly addresses the question of what happens to all of the other contractual duties that are set forth and are normally set forth and imposed on a licensee. I believe that the courts will have to deal with that and it should be left for the courts to deal with it.

If I were asked the question, if I were a bankruptcy judge, which I'm not, that if the licensee elects to retain his rights to the intellectual property, that most of the duties under that license agreement will have to be performed by him—he will be obligated to do so—except such duties as are so directly related to obligations that the licensor has been freed from by the rejection as to make it inequitable.

For example, if there are reciprocal duties dealing with cooperation in case of an infringement, and if, by rejection, the licensor has freed himself from that obligation, it may seem to a bankruptcy court inequitable and a violation of the principle of mutuality of obligation to continue to impose that kind of a burden and duty on the licensee. To that extent, he may escape some burdens. But I think most of these obligations he will still have, just as a lessee in possession of real property, despite the rejection, still has to perform many of the duties and responsibilities under the lease.

That has been in the law for many, many years. I have looked recently and I could not find a single reported case in which that turned out to be a problem. Parties usually work that out among themselves.

Mr. GOLDBERGER. Do the other panelists agree with that? Is it something we should codify or put in legislative history, or is it something that we need not turn our attention to?

Mr. HEMNES. If I may respond briefly to Mr. Hahn, I think that what Mr. Hahn is asking the bankruptcy court to do is to rewrite a very complicated agreement. I think that will impose an administrative burden on the bankruptcy court and I think it's unlikely that it will reach the agreement that the parties would have reached themselves.

Mr. GOLDBERGER. Ms. Shea-Stonum.

Ms. SHEA-STONUM. Thank you very much.

Again, I quibble with the starting point of Mr. Hemnes. By definition, what we're dealing with here is a situation where the debtor in possession or trustee has rejected the agreement. Therefore, my view—and I know this is not wholly without controversy—but my view is that rejection is a synonym for a breach. It's a court-approved breach of the contract, and it's as breach, if you accept Professor Countryman's definition, a breach so material as to excuse the other side from performance.

If the other side elects to treat the contract as still giving rise to rights, I agree with Mr. Hahn. There should be an equitable sorting out. But I think it is very dangerous to try at this point to write any hard and fast rules. I think there should be—I'm not sure whether Mr. Hahn and I would agree on exactly where the fulcrum is. But in my view, if the trustee is receiving payment and has elected not to perform its obligations under the contract, we want to be very careful about not creating a situation where there's going to be a huge incentive in almost every case for the debtor in possession or the trustee to reject these contracts because it's a "get your cake and eat it, too" sort of situation.

At one point, in correspondence with Mr. Hemnes, he suggested that the licensee's obligation, for instance, to share improvements should go forward. 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. I think Congress can set broad guidelines, but I would be very concerned about trying to sort out these issues in detail and would agree with Mr. Hahn, that we should leave it to equitable resolution by courts.

Mr. GOLDBERGER. Thank you.

One final question. What is the effect of this bill on sublicensees? Mr. Hemnes, do you want to answer that?

Mr. HEMNES. Well, not having authored it, obviously, I don't want to pretend to speak for those who did. But I would understand it as allowing a sublicensee to retain rights not only in the intellectual property owned by its immediate licensor, but also in intellectual property owned by the prime licensor in which it acquires a sublicense. That is one of the problems, as I say, that I see in the legislation, that it would require that prime licensor, who is probably not a party to the bankruptcy proceedings, to rush into court to protect its intellectual property after a rejection by its licensee.

There is a further problem, if I may expand a little bit. If the sublicensee pays the licensor, the bankrupt licensor, the amounts owing under this proposed legislation, presumably the prime licensor would have only an unsecured claim for a recovery against the bankrupt estate for the amounts owing to it under the prime license. I think that would create an inequity as to the prime licensor.

Mr. MANBECK. May I comment?

Mr. GOLDBERGER. Certainly, Mr. Manbeck.

Mr. MANBECK. I suggest to you there are two sublicensee situations. One is where the prime licensor is the bankrupt. Now, as I read this bill, the immediate licensee may then elect to keep its license. The way sublicenses are written, they are usually written as a license with the right to sublicense. So I think logic says to us that the licensee who elects to keep his license and thereby elects to keep the rights for the sublicensee must, of course, make payment for the sublicensee's activities. If the licensor has done any kind of decent legal drafting job at all, he has stuck the licensee to make the sublicensee's payments, so that they will come flowing through.

Now, we have the other side, where it is the licensee who has gone bankrupt. In that case, if he does not make his payments, the licensor will have a right to terminate because of the failure to make the payments. Of course, the sublicensee is going to be no better off than the licensee who does not make his payments. So I don't know that we're really getting at that problem in this bill.

Mr. GOLDBERGER. Thank you, Mr. Manbeck.

Mr. Chairman, thank you.

Mr. EDWARDS. We could pursue that issue for a while, but I'm sorry, we don't have time. It is very interesting.

We invite further comments by all of the witnesses here. Your testimony has been very, very valuable. Thank you all for being here today and offering such fine testimony.

The subcommittee is adjourned.

[Whereupon, at 11:25 a.m., the subcommittee was adjourned.]

APPENDIX

TESTIMONY OF JEFFREY L. TARKENTON
HUNTON & WILLIAMS
ON BEHALF OF
AMERICAN BANKRUPTCY INSTITUTE

On behalf of the American Bankruptcy Institute, I extend my sincere appreciation to the Chairman and the Members of the Subcommittee for the opportunity to present testimony to you regarding H.R. 4657. The ABI is a nonpartisan membership organization of more than 2,200 lawyers, judges, accountants, bankers, business leaders, professors and others who are actively involved with the operation of the nation's bankruptcy laws. While I appear before you as a representative of the ABI, the views I express are necessarily my own and do not represent the official view of the ABI.

The two fundamental policies underlying the Bankruptcy Code are that creditors should be treated equally and that debtors should have an opportunity for a fresh start. Congress carefully crafted the Bankruptcy Code in order to balance these two competing policies. When the Bankruptcy Code is amended, there is always a risk that this balance will be lost. Where the Bankruptcy Code is altered to benefit particular groups, the change may be made at the expense to other parties in interest thereby rendering the Bankruptcy Code less effective in balancing competing interests.

The provisions of Chapter 11 illustrate this balance. These provisions give each player in the reorganization process certain bargaining power. By distributing bargaining power, Congress ensured that in most cases a confirmed Chapter 11 plan would be the result of negotiation and compromise.

The proposed legislation will not upset the balance which Congress crafted. Instead, it will effectively balance the competing interests of creditors, trustees and debtors in possession in a section of the Bankruptcy Code which, because of the decision by the Fourth Circuit Court of Appeals in Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043 (1985), cert. denied 475 U.S. 1057 (1986), there is a glaring lack of balance.

The Bankruptcy Code containes few restrictions that limit a debtor's right to reject an executory contract. Under executory contracts, the debtor can, subject to court approval and subject to certain exceptions, assume or reject an executory contract provided that in the debtor's business judgment the assumption or rejection is in the estate's best interest. Generally, a debtor enjoys material benefits and has material obligations under an executory contract. In the context of intellectual property licenses, when the debtor rejects an executory contract, it avoids its obligation to perform its contractual duties and it loses the benefits it would receive if the other contracting party performed its duties under the license agreement. Because of the development of the system of granting rights for the use of intellectual property, often the licensee's sole responsibilities under the executory contract are to pay royalties and to maintain the confidentiality of the intellectual property. Meanwhile, the licensor enjoys the royalties which the licensee pays for the use of the intellectual property.

The system of licensing the use of intellectual property, rather than transfering ownership, evolved as a method of ensuring that intellectual property would have wide opportunities for development. The Lubrizol decision imperils this system. In Lubrizol, the court permitted Richmond Metal Finishers, the licensor and debtor in possession, to reject its nonexclusive technology-licensing agreement with Lubrizol. The court not only permitted the debtor to reject its future performance obligations, but also permitted the debtor to completely rescind the completed transfer of technology. Under the Lubrizol decision, the debtor can strip the other contracting party of intellectual property which was transferred long before the debtor filed its bankruptcy petition.

Since § 365 of the Bankruptcy Code was enacted in part to relieve debtors of burdensome obligations of future performance, the Lubrizol decision enables debtor licensors to use this shield against burdensome obligations as a sword to unravel completed transfers of intellectual property. For example, a licensor whose intellectual property has increased in value can in bankruptcy reject an executory contract involving the license of the intellectual property, license use of the intellectual property to another party, and reap substantially higher royalty payments than it reaps under the existing license. The licensor may file bankruptcy to take advantage of this right to rescind which does not exist outside of a bankruptcy proceeding. By rejecting the license, the debtor licensor can deprive the licensee of irreplaceable intellectual property which it has invested in and developed.

Because a debtor licensor can reject an executory contract involving the license of intellectual property and thereby deny the licensee the right to use the intellectual property in the future, licensees face great risk when deciding whether to invest through research and marketing in order to develop products based upon the license. Because licensees can not be assured that they will be able to retain the intellectual property rights which they have a license to use, their incentives to use the licensed intellectual property to develop products is chilled. Furthermore, as noted above, the Lubrizol decision encourages licensors to file bankruptcy petitions and reject licenses where the intellectual property has substantially increased in value. The proposed amendment is a principaled solution to this problem.

The proposed amendment treats intellectual property rights in a manner which is similar to the manner in which the Bankruptcy Code treats other unique rights such as real property leases. The new bill has been drafted to parallel the existing provisions of 11 U.S.C. § 365(h)(1). Section 365(h)(1) provides that where a debtor lessor rejects an unexpired lease of real property, the lessee may treat the lease as terminated or, alternatively, may remain in possession of the real property for the balance of the lease term and for any renewal or extension of the term that is enforceable under nonbankruptcy law.

In a similar manner, the bill would permit the licensee of intellectual property rights to retain the rights which were conveyed to him prior to the licensor's filing of a bankruptcy petition. If the debtor licensor rejects the license, the licensee either may treat the executory contract under which the debtor is the licensor of rights in intellectual property as terminated or may retain its rights for the balance of the licensee's term and any renewal or extension thereof. If the licensee elects to retain its rights in the intellectual property, then the licensee must make all payments due under the executory contract for the balance of the term and for any renewal or extension thereof. However, if the licensee elects to retain the rights, it is deemed to waive any offset rights for claims arising out of the rejection of the contract. As a result, the licensee may not offset claims it has arising out of the debtor's nonperformance of its obligations under the executory contract against the licensor's rights to receive royalty payments which might be crucial to its reorganization.

Although the drafters exercised a great deal of care and skill in drafting H.R. 4657, the language found at section 1(a) of H.R. 4657 regarding the definition of intellectual property should be more explicit. In order to avoid confusion, the legislation should specify that intellectual property includes patents and copyrights.

The proposed legislation does an excellent job in establishing a balance between the interests of licensees and debtor licensors. If this bill is enacted, debtor licensors will not be able to unravel transfers of intellectual property which were completed long before the bankruptcy filing. Although the bill eliminates the incentive some debtor licensors face to reject existing licenses in order to execute new, more lucrative licenses, the bill does not hinder the debtor licensor's opportunities to effectively reorganize.

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