BANKRUPTCY AND THE TRUSTEE'S POWER TO DISCLAIM INTELLECTUAL PROPERTY AND TECHNOLOGY LICENSING AGREEMENTS: PREVENTING THE CHILLING EFFECT OF LICENSOR BANKRUPTCY IN CANADA*

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1.0 INTRODUCTION

> It cannot be gainsaid that allowing rejection of such contracts as executory imposes serious burdens upon parties such as Lubrizol. Nor can it be doubted that allowing rejection in this and comparable cases could have a general *chilling effect* upon the willingness of such parties to contract at all with businesses in possible financial difficulty.[1]

Notwithstanding the express recognition of the chilling effect that the rejection of an executory contract could have on the technology industry, the Fourth Circuit Court of Appeals in *Lubrizol* upheld the trustee's right to disclaim a licensing agreement.[2]

The purpose of this article is to determine whether this "chilling effect" could occur in Canada by examining whether the trustee has the power to disclaim an executory contract under the authority of the *Bankruptcy and Insolvency Act*[3] or the common law. Our focus will be on intellectual property and technology licensing agreements and the effect of the rejection of these agreements on licensee's in particular and the technology industry in general.

We will begin by canvassing the pertinent authorities in the United States in order to establish the state of the law both before and after the coming into force of the 1988 amendment to the *Bankruptcy Code*.[4] We will define the notion of an "executory contract" and apply the definition to an intellectual property and technology licensing agreement.

In considering the application of Canadian law to the licensor's bankruptcy and the trustee's power to reject an executory agreement, both the relevant provisions of the *Bankruptcy and Insolvency Act* and the trustee's common law rights will be reviewed.

Third, we will consider the implications of executing an escrow agreement on the rights of the licensee subsequent to the licensor's bankruptcy. Finally, our conclusion will distinguish American and Canadian law on this issue as we contend

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that Canadian law must be interpreted differently thereby avoiding a *Lubrizol* "chilling effect." Let us begin with the state of the law in the United States.

2.0 THE STATE OF THE LAW IN THE UNITED STATES

2.1 Trustee's Power To Disclaim Licence Agreements

2.1.1 Definition of "Executory Contracts"

Section 365(a) of the *Bankruptcy Code* provides that, with certain exceptions, the trustee may assume or reject "any executory contract" of the debtor subject to the approval of the bankruptcy court.[5] Most notably, the section does not offer a statutory definition of "executory contract." However, the U.S. Supreme Court in *N.L.R.B. v. Bildisco & Bildisco*[6] cited the intent of the draftsmen of the 1978 *Bankruptcy Code* to the effect that executory contracts included contracts under "which performance remains due to some extent on both sides" and specifically embraced this view of executory contracts.[7]

In the *Bildisco* case, the Supreme Court held that a collective bargaining agreement was an executory contract within the meaning of s. 365(a). The bankruptcy court should therefore uphold the debtor's right to reject the collective bargaining agreement, if the debtor can show that the agreement burdens the estate and that the equities balance in favour of rejection. According to the U.S. Supreme Court, the text of s. 365(a) "indicates that Congress was concerned about the scope of the debtor-in-possession's power regarding certain types of executory contracts, and purposely drafted 365(a) to limit the debtor-in-possession's power of rejection or assumption in those circumstances."[8]

The definition of "executory contract" was first proposed in 1973 in an extensive two-part article by Professor Vern Countryman. According to the Countryman definition, in order for a contract to be executory the "obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete the performance would constitute a material breach excusing the performance of the other."[9]

The Countryman definition contains some of the same elements as the definition proposed by the draftsmen of s. 365(a) of the *Bankruptcy Code* and embraced by the U.S. Supreme Court in *Bildisco*. There must be unperformed obligations and these unperformed obligations must be mutual. Subsequent case law has adopted the Countryman definition in establishing whether or not a contract is executory.[10] Let us now examine how American jurisprudence has dealt with the characterization of licensing agreements as executory.

2.1.2 Licensing Agreements as Executory Contracts

One of the first cases dealing with the termination by a trustee of a licence agreement subsequent to a licensor's bankruptcy was the 1980 decision by the Ninth Circuit of

the U.S. Court of Appeals in *Re Select-a-seat Corp.*[11] The court held that a computer software licensing agreement is executory.[12]

The facts in the case reveal that Select-a-seat had developed a software package that permitted reservations to various events to be made electronically. The "Worldwide Licensing Agreement" with Fenix granted Fenix, upon payment of a $140,000 flat fee plus 5 percent of Fenix's annual net return from the use of the software, the exclusive rights to use and license Select-a-seat's software package in all but five areas of the world that had been previously allocated to Select-a-seat subsidiaries. Conversely, Select-a-seat had a continuing obligation not to sell its software packages to other parties. By virtue of the agreement, a violation of either the annual payment obligation or the exclusive dealing obligation would constitute a material breach of the agreement.

In deciding that the bankruptcy court had properly upheld the trustee's right to terminate the licensing agreement, the appellate court adopted the Countryman definition of executory contract to the case at bar and declared the agreement executory as to Select-a-seat. In other words, the court found that the obligation of a debtor to refrain from selling software packages to other parties under an exclusive licensing agreement made the contract executory as to the debtor, notwithstanding the continuing obligation of forbearance. Select-a-seat's obligation to not sell its software packages to other parties is a future performance. In the words of the Ninth Circuit Court:

> The trustee merely sought to reject the executory portions of the contract, the continuing warranty and exclusive dealing obligations. These obligations are analogous to executory covenants in leases to provide heat or electricity; the lease (here, the licence) cannot be summarily terminated, but rejection can cancel covenants requiring future performances by the debtor.[13]

Finally, the appellate court deferred to the bankruptcy court's decision that the licensing agreement was burdensome to the bankrupt estate and thus Fenix could only file a claim for damages incurred as a consequence of the agreement's rejection as an ordinary creditor of the estate.

The oft-cited 1985 decision by the Fourth Circuit Court of Appeals in the *Lubrizol*[14] case found an industrial processes licensing agreement executory and confirmed Professor Countryman's test for determining whether a contract is "executory" as the Ninth Circuit had done in *Re Select-a-seat*.

In the case at bar, Lubrizol Enterprises entered into a non-exclusive licence in July 1982 to use a metal coating process owned by Richmond Metal Finishers (RMF). In order for the court to determine that the contract was executory within the meaning of the *Bildisco* decision and the Countryman test, there must be mutual unperformed obligations at the time of the filing of bankruptcy.

RMF's obligations were to notify Lubrizol of and defend Lubrizol in any patent infringement suit; to notify Lubrizol of any other use or licensing of the process and to reduce royalty payments if another licensee was paying a lower royalty rate; and to indemnify Lubrizol for losses arising out of any misrepresentation or breach

of warranty by RMF. As for Lubrizol's obligations, they were to defer use of the process until a specified date;[15] to keep all licence technology in confidence for a number of years; and to perform duties of accounting for and paying reciprocal royalties for use of the process and the cancelation of existing indebtedness.[16]

The court's finding of fact with respect to RMF was that it owed core obligations of notice and forbearance to Lubrizol. Although the licence to Lubrizol was not exclusive, the reasoning of the Ninth Circuit Court in *Re Select-a-seat* to the effect that a breach of an unperformed continuing duty of forbearance clearly constituted a material breach of the agreement was also adopted by the *Lubrizol* court thus rendering the contract executory.

As for Lubrizol, it owed RMF the continuing duty of accounting and paying royalties for the duration of the agreement. The obligation to make fixed payments to the other party does not in and of itself render a contract executory; however, "the promise to account for and pay royalties required that Lubrizol deliver written quarterly sales reports and keep books of account subject to inspection by an independent Certified Public Accountant."[17] These obligations go beyond the promise to pay money and thus the contract is executory.

The policy considerations underlying a rejection of a licensing agreement and the subsequent "chilling effect" of such a burden were analyzed by the court:

> But under bankruptcy law such equitable considerations may not be indulged by courts in respect of the type of contract here in issue. Congress has plainly provided for the rejection of executory contracts, notwithstanding the obvious adverse consequences for contracting parties thereby made inevitable.[18]

The Fourth Circuit Court distinguished technology licensees from the "special treatment" given by the Supreme Court to union members under a collective bargaining agreement in *Bildisco* and to lessees of real property under s. 365(h) of the *Bankruptcy Code* and concluded that "no comparable special treatment is provided for technology licensees such as Lubrizol. They share the general hazards created by section 365 for all business entities dealing with potential bankrupts in the respects at issue here."[19]

Essentially, the *Lubrizol* court held that equitable considerations should not be indulged by bankruptcy courts when determining whether a rejected licence agreement is executory, notwithstanding the ensuing result of the licensee being only an ordinary creditor in the bankruptcy. This result upsets the stability of licensing agreements and thus makes licensees reluctant to rely on licensed technology given that the licence could be repudiated by the bankruptcy of the licensor leading to a chilling effect on licensing in the technology industry.

The jurisprudence has therefore generally classified licence agreements as executory. This classification also applies to the typical intellectual property and technology licence because both the licensor and licensee have the continuous obligations discussed in the above *Re Select-a-seat* and *Lubrizol* decisions. The following passage from Professor Countryman confirms this view:

> The usual patent license, by which the patentee-licensor authorizes the licensee to exercise some part of the patentee's exclusive right to make use, and vend the patented item in return for payment of royalties, ordinarily takes the form of an executory contract.[20]

On the other hand, "[w]here there is no express undertaking by the licensor, the agreement with the licensee may not be executory because the licensor may have fully performed merely by executing the license agreement."[21] This scenario, however, is quite unusual given that the licensor has a minimal obligation of forbearance. In conclusion, for the purposes of s. 365(a) of the *Bankruptcy Code*, intellectual property and technology licensing agreements are executory.

2.1.3 Amendments to the Bankruptcy Code

The 1985 *Lubrizol* case above prompted the 1988 amendment to the *Bankruptcy Code*, which introduced s. 365(n).[22] "By implementing Section 365(n) Congress sought to reverse the potentially chilling effect on the licensing of intellectual property as a result of the *Lubrizol* decision."[23]

The amendment was designed to balance the licensee's interests in continuing to exercise the rights conferred by the licensing agreement with the licensor's right to terminate the agreement to allow for a restructuring of the insolvent company. This balance was achieved by giving the licensee the option to accept the trustee's decision to terminate the contract or to continue using the licensed technology. As such, "Congress designed Section 365(n) to allow the intellectual property licensee, upon rejection of the license agreement by the debtor/licensor, the option to either 'retain its rights' in the intellectual property, while continuing to pay royalties, or to treat the executory contract as terminated."[24]

According to s. 365(a) of the *Bankruptcy Code*, a trustee must obtain court approval before either assuming or rejecting an executory contract. In granting such approval, the court will evaluate the trustee's or debtor's motion for authority to assume or reject an executory contract under the "business judgment" standard.[25] The standard "focuses on the benefit derived by the debtor's bankruptcy estate and its creditors from the proposed treatment of the executory contract under Section 365 of the Bankruptcy Code."[26] An executory contract must be assumed or rejected in its entirety.[27]

The trustee's or debtor's decision will generally be approved by the court in its application of the business judgment standard, unless the bad faith or abuse of discretion of the trustee or debtor can be shown. It is not the court's function to make business decisions and as such "courts should defer to—should not interfere with—decisions of corporate directors upon matters entrusted to their business judgment except upon a finding of bad faith or gross abuse of their 'business discretion.'"[28]

Significantly, the 1988 amendment to the U.S. *Bankruptcy Code* excluded "trade-mark" from the Code's definition of intellectual property in s. 101(52). As a result, s. 365(n) does not apply to the trade-mark licensee, who therefore remains in the same precarious position as all licensees of intellectual property held subsequent to the *Lubrizol* decision.[29]

For example, in *Re Chipwich Inc.*,[30] the Second Circuit held that the debtor could reject an executory contract granting licences to produce and sell certain products under the debtor's trade-mark. The debtor, Chipwich Inc., granted two licences to Farmland Dairies Inc.

The first licence agreement granted the licensee an exclusive franchise and licence in the United States to use the "Chipwich" trademark on the licensee's egg-nog product in exchange for a $15,000 initial fee and royalties. The second agreement granted Farmland the right to use the trade-mark worldwide on its dairy shake product for $75,000 plus royalties.

The court relied on the reasoning in the *Lubrizol* decision and concluded that the agreements were executory. In essence, the debtor's obligations in *Chipwich* and *Lubrizol* were similar and, given that the consideration of paying royalties on Farmland's part was continuous, the result in *Chipwich* follows the one enunciated by the Fourth Circuit Court in *Lubrizol*. The 1988 amendment to the *Bankruptcy Code* does not change this result with respect to trade-marks.[31]

2.2 The Effect of Section 365(n) on the Technology Industry

The "chilling effect" that the *Lubrizol* decision could have produced in the technology industry over a period of time was thwarted by Congress in 1988. The trustee's rejection of the licensing agreement during the impending reorganization in bankruptcy of the licensor's estate or subsequent to the bankruptcy was a real threat to the licensee's future commercial viability. The amendment to s. 365 of the *Bankruptcy Code* was designed to offer contractual stability to licensees without fettering the trustee in bankruptcy's power to reject a licensing agreement in the interest of the reorganization of the debtor's estate.

> The Intellectual Property Bankruptcy Act of 1988 strikes a fair balance between the need of licensees of intellectual property to be able to rely on the licensing agreements they enter into and need of the bankrupt licensor to be free from burdensome obligations in order to reorganize. Under this law, the licensee is assured that his rights to the intellectual property cannot be extinguished by the debtor, and the debtor/licensor will not be unduly restrained by the duty to perform continuing affirmative obligations after he has declared bankruptcy.[32]

The use of the licensing agreement as an instrument to promote the development of commerce in the technology industry is thus preserved. We can conclude that the 1988 amendment to the *Bankruptcy Code* enacting s. 365(n) "revives licensing in the technology industry since the 'chilling effect' of *Lubrizol*, and does so without severely burdening the bankrupt debtor's section 365 right to reject executory contracts under the Bankruptcy Code."[33]

3.0 THE STATE OF THE LAW IN CANADA

3.1 The Trustee in Bankruptcy's Power To Disclaim Contractual Obligations of the Debtor

3.1.1 Trustee's Power To Administer Bankrupt's Property under the BIA

Upon bankruptcy, the general rule is that the trustee "steps into the shoes of the bankrupt" except where statute provides otherwise.[34] It is the duty of the trustee to take possession of the property of the bankrupt as soon as possible following the date of bankruptcy in accordance with the duties and powers conferred upon the trustee by the *Bankruptcy and Insolvency Act* (BIA).[35] The trustee must administer the bankrupt estate for the benefit of the mass of creditors, including any incomplete contract entered into by the bankrupt prior to bankruptcy. In *Re Bakermaster Foods Ltd.*,[36] the court ordered the trustee not to close a sale of land entered into by the bankrupt prior to the bankruptcy because the subsequent deficit would prejudice the unsecured creditors. According to Henry J., "[t]he overriding principle is that the trustee and the court must protect the assets of the estate for the benefit of the unsecured creditors."[37]

Around this general policy there are a number of issues involved in assessing the specific effect of the bankruptcy of a licensor. These include whether or not the licence can be considered the property of the bankrupt, the effect on the licensee of how a trustee may treat an incomplete contract of the bankrupt, and how the bankruptcy affects the contractual rights of the other party to the contract.

The first step in being able to address these issues is to consider what is contemplated by the term "property" in the BIA. The Act defines property as follows in s. 2:

> "property" includes money, goods, things in action, land and every description of property, whether real or personal, legal or *equitable*, and whether situated in Canada or elsewhere, and includes obligations, easements and every description of estate, *interest and profit*, present or future, vested or contingent, in, arising out of or incident to property. [Emphasis added.]

There has not been a great deal of consideration as to the scope of this definition, particularly in relation to what constitutes an *interest or profit* and *equitable* property. Courts have concluded that goodwill is an interest within the scope of the above definition.[38] We will focus on the inclusion of licences in this definition in order to conclude that licences vest in the trustee subsequent to the bankruptcy of the licensor.

Although we were unable to find a case directly considering whether the s. 2 definition of property subsumes within it a licence of intellectual property, the jurisprudence we canvassed did define commercial fishing licences as property.

In *Re Bennett and Bennett*,[39] Ryan J. considered whether a commercial fishing licence in the name of the bankrupt passed to the trustee on the assignment in bankruptcy. The licence was claimed to be "non-transferable, non-exigible and not available

for the general benefit of creditors." However, an industry practice existed whereby the licensee could transfer the "beneficial interest" in the licence.

Although not explicitly sanctioned, the minister of fisheries and oceans allowed this practice. Ryan J. found that such a licence was contemplated by s. 2 of the BIA. He found the last phrase in the definition particularly instructive. According to Justice Ryan, "the right to fish for roe herring must at least be an 'interest' or 'profit in,' or arising out of or 'incident to property' " and that although the licence was non-transferable, a beneficial interest in it vested in the trustee in bankruptcy.[40]

The nature of a licence is simply a contractual agreement between the copyright owner and the licensee under which the copyright owner agrees not to exercise its ownership rights against the licensee.[41] In English law, there is no transfer of property rights onto the licensed subject. The English case of *Heap v. Hartley*[42] makes this proposition clear: "A dispensation or licence properly passes no interest but only makes an action lawful which without it would have been unlawful."[43] Canadian law followed suit and the licence of intellectual property rights is thus a personal right conferred by the licensing agreement.[44]

3.1.2 The Trustee in Bankruptcy's Power To Disclaim under the BIA

As we have already stated, a contract may be executed or executory. A trustee in bankruptcy acquires an interest in the bankrupt's property, including executory contracts, subject to any existing equities. Thus, the trustee in bankruptcy must honour any contract that creates an equitable interest in property, just as the bankrupt itself would have had to honour it. To this effect, Houlden and Morawetz state the following:

> Apart from statutory provisions, such as those dealing with fraudulent preferences and settlements, a trustee only succeeds to the rights of the bankrupt and has no higher or greater rights … . The trustee is only a successor in interest. (*Flintoft v. Royal Bank of Canada*, [1964] S.C.R. 631.) …
>
> If a bankrupt has validly alienated his property prior to the date of bankruptcy, the trustee will have no right to claim the property. The bankrupt could not have claimed an interest in the property, and the trustee has no better right. …
>
> If the bankrupt at the time of acquiring an interest in property has entered into a valid agreement concerning the interest of some person in the property, that agreement will be binding on the trustee. (*In Re Frechette*; *Daoust v. Compagnie de Gestion Car-Vin Inc.* (1982), 42 C.B.R. (N.S.) 50 (Que. S.C.), a shareholders' agreement had been entered into which, among other things, gave other shareholders the right to purchase the shares of any shareholder who became bankrupt. One of the shareholders went into bankruptcy. It was held that, since the trustee had no greater rights than the bankrupt, the agreement was binding on the trustee, and the trustee was obliged to sell the shares to the remaining shareholders.[45]

In addition, once a receiving order has been filed, the bankrupt ceases to have the capacity to deal with his or her property.[46] From that point on, the property vests

in the trustee. This includes the ability to take or continue legal proceedings in its own name and the ability to dispose of property.

However, in *Re Olympia & York Developments Ltd.*,[47] the Ontario Court of Justice held that where a bankrupt has entered into bona fide contractual arrangements regarding certain assets, those assets will not form part of the property of the bankrupt. Therefore, the receiving order would have the effect of having all property of the bankrupt devolve upon the trustee, except that property previously alienated in a bona fide fashion.

There are some decisions discussing whether the beneficial interest in a contract constitutes property that vests in the trustee. In *Stead Lumber Co. Ltd. v. Lewis*,[48] Walsh C.J. states that

> [b]ankruptcy in and of itself does not discharge a contract. The property of a bankrupt, including the benefit of his contracts (other than contracts of a personal nature) vests immediately on his adjudication in the trustee in his bankruptcy, who is entitled to perform any executory contracts for the benefit of the bankrupt's estate (8 Halsbury's Laws of England 3rd ed. pp. 200-1).[49]

The *Stead Lumber* decision cites English law to the effect that in England a trustee possesses a statutory right to disclaim an executory contract. "As regards those contracts which the trustee can perform, he may elect either to adopt or disclaim them (2 Halsbury's Laws of England 3rd ed. p. 427)." [50]

There is further authority in support of this decision. In the *Thomson Knitting*[51] case, the court held that bankruptcy could constitute a breach of a tender contract, rendering it null if the trustee did not perform the bankrupt purchaser's obligations in the contract within a reasonable time, that is before the first meeting of creditors. The proposition that the carrying on of the bankrupt business by the trustee must be necessary for the beneficial administration of the estate was upheld in a case involving the completion of a contract by the trustee three years after the receiving order was issued.[52]

In a case comment following the *Potato Distributors* case, L.W. Houlden writes laconically and without much further comment:

> It is well established law that a trustee may elect to carry on with a contract entered into prior to bankruptcy, provided he pays up arrears and is ready to perform the contract. The trustee could also if he saw fit, elect not to go on with the contract in which event the vendor would have had the right to prove a claim for damages.[53]

The above proposition by Houlden and Morawetz to the effect that the trustee only succeeds to the rights of the bankrupt and has no higher or greater rights was quoted with approval in *Re Erin Features #1 Ltd.*[54] This case involved a marketing agreement by which the corporation in issue granted exclusive marketing rights in Canada for a film started by the corporation and finished by the creditors. When the corporation went bankrupt, the trustee in bankruptcy applied to the court for permission to disclaim this agreement. The court held that this agreement involved a

conveyance of the marketing rights before bankruptcy, which the trustee in bankruptcy could not reverse:

> Assuming without deciding that a trustee in bankruptcy generally possesses a power to disclaim, I hold that the contract in issue here does not fall within the category of executory contracts which may be subject to disclaimer. Erin Features sold its Canadian marketing rights to the film to MGM and accordingly the trustee cannot now assert the right to reverse that sale after bankruptcy simply because there is an element of the contract of sale which remains to be carried into operation. In other words, the property was validly conveyed and no special power under bankruptcy exists to reverse that conveyance.[55]

It should be noted that the Court refused to rule on whether a trustee in bankruptcy generally has the power to disclaim an executory contract "[s]ince the statute is silent on the point and the matter fraught with difficulty."[56] As we will demonstrate, several authors take the view that a trustee has neither the statutory nor the common law right to disclaim a licensing agreement.

In a case comment on *Re Erin Features #1 Ltd.*, Gabor F.S. Takach and Ellen Hayes[57] were critical of the judge's analysis in rendering the decision. The authors put forth the argument that a trustee in bankruptcy in Canada has no common law right to disclaim contracts entered into before bankruptcy for several reasons. First, they argue that the term "disclaim" has a technical meaning both in England and the United States since there are specific statutory provisions empowering the trustee to disclaim an executory contract. However, "unlike in England and the United States, there is no statutory provision in the *Bankruptcy Act* (Canada) that authorizes a trustee generally to disclaim or reject executory contracts."[58]

Second, they contend that the Canadian authorities relied upon by the judge to support a trustee's right to disclaim are largely *obiter*.[59] Moreover, it is unclear whether a common law right to disclaim contracts existed in England prior to the statutory provisions being enacted. As such, "recognizing a common law power to disclaim ignores the doctrine that a codified body of law should be interpreted without reference to the pre-existing common law."[60]

Finally, Takach and Hayes set forth the alternative argument that property vests in a trustee in bankruptcy subject to an equitable interest in a negative covenant. They suggest that the court in *Re Erin Features #1 Ltd.* could have found that the exclusive marketing rights granted under the marketing agreement, necessarily imports a negative covenant to not grant any further marketing rights. This negative covenant could be enforced by a court of equity by way of injunction.[61]

The authors conclude that the *Lubrizol* effect would not be reproduced in Canada.

> It is our view, however, that once the disclaimer issue is squarely before the court and authorities carefully analyzed, the court will conclude that trustees have no general right to disclaim contracts in Canada. We also believe that if a trustee of a licensor attempted to breach or abandon a licensing contract, such an attempt would likely be

met with a successful injunction application by the licensee and that *Lubrizol* will not be repeated in Canada.[62]

The main question of the present article lies in whether the "chilling effect" stemming from the *Lubrizol* decision in the United States would occur in Canada. In other words, absent any legislative reform, will the Canadian technology industry, and particularly the licensees, face the possibility of having the trustee in bankruptcy disclaim the licensing agreement that permits them to do business. Assuming Canadian trustees do possess such a power, there is no equivalent provision to s. 365(n) of the U.S. *Bankruptcy Code* in Canada to protect licensees against the termination of their licensing agreements upon the licensor's bankruptcy. That is why several authors favour legislative reform similar to the 1988 amendment to the U.S. *Bankruptcy Code*.[63]

However, absent any such reform, in applying the principles of the *Lubrizol* decision to Canadian law and specifically to software licences, there are several reasons why a *Lubrizol* result would not occur in Canada.

The definition of what is an executory contract depends on the type of licensing agreement—the specific obligations of the licensor and licensee contained in the agreement being adapted according to the specific industry needs.

As we have shown, defining a contract as executory according to the Countryman definition is the first step in determining whether a trustee has the power to disclaim an agreement. Not all software licensing agreements are executory. Software licenses conveying proprietary rights would not be considered executory in nature given the outright transfer of intellectual property rights[64] and the *Lubrizol* decision can thus be distinguished.

We must keep in mind that the *Lubrizol* decision involved a licensing agreement for a metal coating product (and not a software licence) wherein the licensor had a duty to inform the licensee if it granted a third party more favourable licence terms. As such, *Lubrizol* is distinguishable given that the above "sorts of provisions are quite rare in commercial software arrangements involving off-the-shelf products."[65]

The executory provisions found in the metal coating process agreement with regard to royalty payments are also rarely found in software agreements because "most software licenses involve a single, lump sum payment, so this is yet another factor by which to distinguish *Lubrizol*."[66]

A statutory interpretation argument may also be brought forth to distinguish *Lubrizol* in Canadian law. The BIA does not contain a general provision granting the trustee the right to disclaim an executory contract such as s. 365(a) of the *Bankruptcy Code*.[67] In addition, the Canadian Parliament in enacting the BIA has overridden any common law right that a trustee may claim in disclaiming an executory contract. It is well-established law that legislation is paramount over the common law.[68]

It is unclear whether a common law right to disclaim existed in England prior to the English statute being enacted. The *Stead Lumber* decision, above, points to the

specific English law that granted the trustee the power to either assume or disclaim an executory contract thereby supplanting any common law rule, if any. We therefore contend that a common law right to disclaim an executory contract was never imported from the English common law into Canadian law. In fact, the English law precedes the Canadian law. The original BIA was enacted by the Parliament of Canada in 1919 and came into force on July 1, 1920,[69] whereas the original English statute is 19th century legislation.[70]

The BIA, however, does address the trustee's right to disclaim real property leases in its paragraph 30(1)(k).[71] In fact, s. 30 of the BIA enumerates the acts that the trustee may do with the permission of the inspectors. Most notably, s. 30 does not list disclaiming licensing agreements as an act that the trustee may accomplish as is the case with real property leases. In addition, the court in the *Re Palais des Sports*[72] decision did not give effect to s. 30(1)(k) in the case of the bankruptcy of the lessor and thus further restricted the trustee's powers to disclaim a real property lease by virtue of s. 30 of the BIA. *A fortiori*, s. 30(1)(k) would not apply to the case of the rejection of a licensing agreement in a licensor's bankruptcy.

We agree with the conclusion reached by George Takach,[73] who argues that the combination of all these factors and the distinguishing of the *Lubrizol* decision will produce the following just result:

> Accordingly, in Canada a correct conceptual analysis of the rights of trustees in respect of technology licences would be that, except otherwise provided by statute, a trustee receives the same quality of title in debtor's estate as was enjoyed by the debtor.[74]

In our view, the best interpretation of the state of the law in Canada is that a trustee in bankruptcy may not "disclaim" a contract in the sense that that term is used in England and the United States because there is no specific statutory provision in the BIA nor any common law right in Canada to that effect.

Our position is further supported by the statutory interpretation that is to be given to s. 30 of the BIA. Section 30 lists the specific instances in which a trustee may exercise his powers to reject contracts entered into by the debtor and we contend that these powers must be construed as exhaustive. We recognize, however, that both the jurisprudence that we have canvassed and Houlden and Morawetz point to the trustee's common law power to disclaim an executory contract if it is in the interest of the debtor's estate. We believe this position to be tenuous given the established law to the effect that the trustee succeeds to the rights of the bankrupt, the absence of specific provisions in the BIA and the interpretation principles set forth above.

Finally, the trustee in bankruptcy may always "disclaim" a contract by simply refusing to comply with it because the trustee is not bound to perform the onerous obligations of the bankrupt.[75] In such a case, the creditor could file a claim for damages as an unsecured creditor or petition the court to obtain specific performance of the contract. In exercising his right to not perform the onerous obligation of the

contract, the trustee can greatly prejudice the licensee. In this context we contend that the bankruptcy court may exercise its equitable powers to redress the prejudice. In the *Coopérants*[76] case, the issue was whether an indivision agreement could be set up against a liquidator. The enforcement of the provisions in the indivision agreement was sought by way of specific performance that the Supreme Court distinguished from a monetary debt in the following way:

> In the present case, an application has thus been made for the specific performance of an obligation under a bilateral contract. That obligation differs from a monetary debt for which the consideration has already been received and which, subject to the prior claims provided for by law, is resolved in the event of insolvency by the *pari passu* ranking of the creditors' claims to the proceeds of the winding-up. It is therefore an obligation to do, and more particularly an obligation to give, the subject of which is a unique, non-fungible and indivisible property with respect to which the appellant, as co-owner, has a specific interest and is liable to suffer specific harm.[77]

The principle of contractual stability was therefore key in ensuring that the co-owner would not suffer a specific harm. In this context, the licensee may seek an order in specific performance against the trustee in order to avoid suffering a prejudice for the non-performance of the trustee's onerous obligations. The following conclusion from the Supreme Court of Canada supports this view:

> The principle that must guide the court in exercising its discretion in such a case is that of respect for contracts signed in good faith prior to the winding-up, unless the obligations contained therein are prejudicial to the other creditors and give rise to an unjust preference in light of all the circumstances, in which case equitable relief will be available.[78]

Given that the trustee's first obligation is to the unsecured creditors, this further supports our contention that the trustee cannot cause a creditor prejudice by rejecting the executory contract. The *Coopérants* case can reasonably be applied to bankruptcy matters by analogy as a general principle regarding the application of the equitable powers of the bankruptcy court to such situations.

3.2 Statutory Intellectual Property Protection under the BIA

With few exceptions, the *Bankruptcy and Insolvency Act* does not deal directly with the issue of intellectual property rights. It does, however, deal summarily with patent rights and copyright rights in a manuscript in ss. 82 and 83, respectively.

3.2.1 Patents

Section 82 of the BIA enables the trustee to sell a patented article that had been sold to the bankrupt subject to certain restrictions or limitations free and clear from such restrictions or limitations. Subsection (2) protects the manufacturer or vendor of the patented articles to purchase the articles at the invoice price subject to a deduction for depreciation or deterioration. The section does not deal with the trustee's power to assume or reject an executory contract. However, once the patented articles are

sold under a non-conditional sales agreement they become the property of the bankrupt company within the meaning of the BIA.[79]

3.2.2 Copyright

In s. 83, the BIA affords certain protection to authors who have assigned manuscripts and copyright to a person who becomes bankrupt.[80] The only case that we have canvassed that deals directly with this section is *Re Groupe Morrow Inc.*[81]

The issue in *Re Groupe Morrow Inc.* was a petitioner's claim that it enjoyed the status of a preferred creditor under s. 83(2) of the BIA. The petitioner was the author of two television commercials and owned the copyrights to the works. The debtor had already paid 50 percent of the contract price before the bankruptcy and the petitioner claimed the balance to be paid in installments from the bankrupt estate.

The court rejected the petitioner's motion on the basis that the trustee had not entered into the contract and had therefore sold nothing. Moreover, after an analysis of the dictionary meaning of the word "royalty," the court determined that Canadian and English case law differentiates royalties from fixed fee payments and concluded that the contract was a fixed payment.[82] Accordingly, the payment of "royalties" to the author referred to in s. 83(2)(a) did not apply. In the words of Justice Halperin of the Quebec Superior Court, "In my view, Section 83(2) gives no special right to the author (or the owner) of a copyright for sums due before bankruptcy and which remain unpaid."[83]

We must first conclude from the *Re Groupe Morrow Inc.* case that where there is an agreement for the payment of a fixed sum, it is not considered a royalty within the meaning of s. 83(2). More importantly, s. 83 deals with the bankruptcy of the holder of the copyright, the publisher, and not its owner. The wording of the section confirms these affirmations.[84]

Both ss. 82 and 83 of the BIA were designed to protect the interests of the inventors and authors, respectively. Given this fact and the *Re Groupe Morrow Inc.* decision, the relevance and applicability of these sections to the issue of the bankruptcy of a licensor of computer software from the licensee's perspective is greatly reduced.

3.3 Licensee's Rights and Recourses under Section 65.1(2) of the BIA

The major concern a licensee has upon the bankruptcy of a licensor is to maintain the licence agreement in order to continue to use the software or other intellectual property. However, the BIA deals specifically only with software licences in the context of an insolvent licensee. A licensee's notice of an intent to file a proposal in bankruptcy is governed by s. 65.1 of the BIA.[85]

Although s. 65.1(2) stipulates that the licensing agreement will not be terminated during the restructuring period for failure to pay royalties, it does not provide complete protection for the licensee. "If the contract provides grounds for termination other than those specified (i.e., the fact the debtor is insolvent or had filed under the

BIA or, in the case of a lease, licence or utility supply agreement, the fact that there are arrears) nothing in s. 65.1 would prevent the contracting party from terminating, amending or accelerating payment if the terms of the agreement so provide."[86]

The other contracting party, the licensor, can also petition the court to suspend the stay provisions if it is likely that the subsections of s. 65.1 would "likely cause it significant financial hardship."[87] In sum, the BIA does not offer the licensee much protection when a notice of intention to file a bankruptcy proposal is tabled.

4.0 TRUSTEE'S POWER TO REJECT AN ESCROW AGREEMENT

4.1 Escrow Agreements as Executory Contracts

When computer software is licensed, the source code of the program is rarely distributed to its users in this form. The supplier wants to maintain the trade secret and protect the copyright that is encoded in the source code and will most likely insist that only the object code version of the program is revealed.[88] However, when a licensee must maintain the software, correct errors, and make modifications as required, the source code must necessarily be revealed. In this latter case, the "supplier may refuse to deliver the source code to the customer, but may agree to a source code escrow arrangement whereby the software and all updates and modifications are delivered to a third party for safe keeping, on terms requiring delivery of the software to the user for the limited purposes of maintaining the software, on the happening of specifically enumerated events."[89] These mutual obligations continue throughout the duration of the licence agreement and render the escrow agreement executory. Michael Moody writes:

> Although no court has decided whether a source code escrow agreement is an executory contract, the agreement appears to satisfy the Countryman definition. The licensor has a continuing obligation to deposit with the escrow agent updates and improvements on the software, as well as updated documentation necessary to maintain the source code. The escrow agent has a continuing obligation to hold deposited materials in confidence. Failure to perform either of these obligations would constitute a material breach.[90]

He then concludes, "If a source code escrow agreement is an executory contract, it would be ineffective to protect a licensee in the event of bankruptcy of the licensor because the licensor could merely reject the escrow agreement."[91]

4.2 Drafting Considerations of the Escrow Agreement

In order to reduce the risk of the rejection of the escrow agreement, several authors have suggested that the licensee, in drafting the clauses of the escrow agreement, should

> ensure that the executory obligations are separated, insofar as this is possible, from the licence grant. It is also advisable for the software developer to divest himself absolutely of both the right to possession of the copy of the software placed in escrow and the property rights therein. This precaution may eliminate an executory obligation in the event of the bankruptcy or insolvency of the software owner.[92]

Another analogous solution is to execute an escrow agreement

> structured as two separate agreements—one between the licensor and escrow agent and one between the licensee and escrow agent—to prevent the debtor/licensor from attempting to reject the escrow agreement, as to the licensee, as an executory contract under s. 365 of the *Bankruptcy Code*.[93]

Of course, in the United States the licence agreement need only be qualified as an intellectual property license within the meaning of s. 365(n) to benefit from the amendments to the *Bankruptcy Code.*

Sookman also proposes that the escrow agreement should "provide for the efficient transfer of the rights to the escrowed software on the bankruptcy of the software developer."[94] In order to achieve the same result, Gold proposes a partial assignment. The partial assignment, he contends, is not based on personal rights and thus solves the problem of the escrow agreement being defined as executory:

> If properly drafted, the only difference between an assignment and a licence is that, in the former case, the licence will be entitled to use the software despite a subsequent assignment of the copyright for value, while in the latter case the licence will not be so entitled.[95]

In sum, from a practical viewpoint, separating the executory obligations from the licensing agreement may be insufficient to hold that an escrow agreement is non-executory since the licensor has the continuing obligation to deposit the necessary updates with the escrow agent and the transfer of intellectual property rights from the licensor to the licensee is contrary to the licensor's interests. In the absence of clear case law on the question of the executory nature of an escrow agreement, it is difficult to reach a definitive conclusion on the subject. However, the above drafting considerations may provide a bankruptcy court with traditional reasons to ensure the continuation of a valid technology transfer with escrow prior to the bankruptcy.

5.0 CONCLUSION

Under American law, the *Bankruptcy Code* stipulates that an executory contract may be assumed or rejected by a trustee subsequent to the debtor's bankruptcy. The *Lubrizol* decision, eschewing policy and equitable considerations, gave full force to the trustee's power to disclaim by accepting Professor Countryman's definition that mutual unperformed obligations render a contract executory. The court held that a licensing agreement was executory and could therefore be terminated causing the licensee to lose all rights to exploit the technology and ranking him as an ordinary creditor in the bankruptcy. The "chilling effect" of this decision caused the technology industry in the United States to react immediately.

The American technology industry's response was to lobby Congress to obtain statutory rights protecting licensees from the negative effects of a licensor's bankruptcy. Congress understood that the effects of the *Lubrizol* decision would hinder commerce and amended the *Bankruptcy Code* in 1988. The new legislative scheme

aimed at striking a balance between the licensor's–debtor's right to reorganize and rehabilitate himself or herself and the licensee's–creditor's right to continue exercising its rights by virtue of the licensing agreement.

Our main purpose is to examine how the Canadian technology industry can protect itself against a *Lubrizol*-style decision in Canada. The impact of the bankruptcy of the licensor has not been much researched in Canadian law. Given the absence of equivalent provisions in Canada to those found in the U.S. *Bankruptcy Code* on this issue, the trustee's power to assume or disclaim a licence agreement is not settled law in Canada. As a result, a consensus among a number of authors is growing and these authors are calling for legislative intervention in Canada similar to the 1988 amendment to the U.S. *Bankruptcy Code*. We subscribe to this consensus as a matter of policy. However, at the present time, it is our contention that a *Lubrizol*-style decision would nonetheless not be the proper interpretation of Canadian law and as such the *Lubrizol* chilling effect should not occur in Canada.

We reiterate that both the United States and England have express statutory provisions conferring upon the trustee the right to assume or disclaim an executory contract. The primary difference between American law and English and Canadian law is that no such provision exists in Canada. The statutory interpretation principles set forth in this article demonstrate that legislation is paramount to the common law. In addition, the specific English provisions supersede any common law right that may have existed in England and it is our position that the common law right to disclaim an executory contract, if any, was never imported into Canadian law, especially given the fact that the original Canadian bankruptcy law is subsequent to the first insolvency legislation in England.

In drafting an intellectual property and technology licensing agreement, only the full conveyance of the intellectual property rights would render the licensing agreements non-executory. This scheme would also render the escrow agreements non-executory and prevent their rejection upon the bankruptcy of the licensor. Any other drafting method would have the probable effect of rendering the escrow agreement executory. The determination that a contract is not executory would preclude the trustee from exercising his right to disclaim the contract.

Finally, if Canadian courts were to determine that the trustee has a common law power to disclaim, we take the position that policy and equitable considerations support our conclusion that bankruptcy courts should balance the interests of both the mass of the creditors and the prejudice to the creditor–licensee. From a policy perspective, Parliament has yet to enact a specific provision granting the trustee the right to disclaim an executory contract. Therefore, avoiding the *Lubrizol* "chilling effect" would not be contrary to Parliament's intent. Bankruptcy courts also enjoy wide equitable powers as stated by the U.S. Supreme Court in *Bildisco*. These equitable powers can be exercised by Canadian courts by evaluating the evidence of prejudice to the licensee and benefit for the mass of creditors as the Supreme Court of Canada suggests in the *Coopérants* case. Canadian bankruptcy courts would be well-advised to use their equitable powers as a matter of law and equity to avoid a "chilling effect" on the Canadian technology industry.

ENDNOTES

1 Phillips J. in *Lubrizol Enterprises. v. Richmond Metal Finishers, Inc. (In Re Metal Finishers, Inc.)*, 756 F.2d 1043, at 1048 (4th Cir. 1985), *cert. denied*, 475 U.S. 1057, 106 S.Ct. 1285; 89 L.Ed. 2d 592 (1986) (hereinafter *Lubrizol*).

2 One American author wrote about the risk of the "chilling effect" of the *Lubrizol* decision in these terms:

> One of the greatest risks that a licensee of computer software faces is that the licensor of the computer software will seek relief under bankruptcy laws. Under the Bankruptcy Code, a bankruptcy trustee or debtor in possession may have the right to reject executory contract such as license agreements. If a license agreement is rejected, it constitutes a breach of contract and the licensor has no further obligations to perform under the license agreement.

Michael C. Moody, "The Intellectual Property Bankruptcy Protection Act: Legislative Relief for Software Licensees from Licensor Bankruptcy," [1989] 3 *Software L.J.* 91, at 91-92.

3 *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3. In a study published on May 15, 2001 at http://strategis.ic.gc.ca/SSG/c100260e.html, entitled "Insolvency Law in the Global Knowledge-Based Economy," Industry Canada recognized the symbiotic relationship between an efficient insolvency law and the promotion knowledge-based economy (KBE) by stating that "insolvency law should help foster the entrepreneurship and innovation so vital to the KBE."

4 *Bankruptcy Code*, 11 U.S.C.

5 The full text of s. 365(a) of the *Bankruptcy Code*, 11 U.S.C. (1982 ed.) reads as follows: "Except as provided in sections 765 and 766 of this title and in subsections (b), (c), and (d) of this section, the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor."

6 *N.L.R.B. v. Bildisco & Bildisco*, 465 U.S. 513 (1984) (hereinafter *Bildisco*).

7 *Ibid.*, at 522, note 6.

8 *Ibid.*

9 Vern Countryman, "Executory Contracts in Bankruptcy: Part I" (1973), 57 *Minn. L. Rev.* 439, at 460.

10 See, for example, *Gloria Manufacturing Corp. v. International Ladies' Garment Worker's Union*, 734 F.2d 1020, at 1022 (4th Cir. 1984) and the *Re Select-a-seat Corp.*, *infra* note 11 and *Lubrizol*, *supra* note 1.

11 *Fenix Cattle Co. v. Silver* (*Re Select-a-seat Corp.*), 625 F.2d 290 (9th Cir. 1980) (hereinafter *Re Select-a-seat Corp.*).

12 Not all licensing agreements are considered to be executory. "The courts have found that agreements which constitute an outright conveyance of intellectual property rights

(as opposed to traditional license agreements requiring an ongoing relationship involving mutual obligations between the parties) are not executory contracts." David S. Kopetz, "Beware When Dealing with Licensors of Intellectual Property: Avoiding Potential Pitfalls Facing Licensees and Lenders When Bankruptcy Intervenes" (January 2000), 17(1) *The Computer Lawyer* 21, at 30, note 18.

13 *Re Select-a-seat*, *supra* note 11, at 292-93.

14 *Lubrizol*, *supra* note 1.

15 May 1, 1983; in fact, Lubrizol never used the RMF technology.

16 *Lubrizol*, *supra* note 1, at 1045.

17 *Ibid.*, at 1046.

18 *Ibid.*, at 1048. The bankruptcy court may exercise its powers in equity when considering the issue of reorganization. The U.S. Supreme Court in *Bildisco* stated:

> *Since the policy of Chapter 11 is to permit successful rehabilitation of debtors, rejection should not be permitted without a finding that that policy would be served by such action.* The bankruptcy court must make a reasoned finding on the record why it has determined that rejection should be permitted. Determining what would constitute a successful rehabilitation involves balancing the interests of the affected parties—the debtors, creditors, and employees. [Emphasis added.]

Justice Rehnquist added:

> *The Bankruptcy Court is a court of equity, and making this determination it is in a very real sense balancing the equities, as the Court of Appeals suggested.* Nevertheless, the *Bankruptcy Code* does not authorize freewheeling consideration of every conceivable equity, but rather only how the equities relate to the success of the reorganization. The Bankruptcy Court's inquiry is of necessity speculative, and it must have great latitude to consider any type of evidence relevant to this issue.

Bildisco, *supra* note 6, at 526-27 (emphasis added). Section 105 of the *Bankruptcy Code* grants the bankruptcy court the power to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." For a further discussion of s. 105 see John Musone, "Crystallizing the Intellectual Property Licenses in Bankruptcy Act: A Proposed Solution to Achieve Congress' Intent" (1997), 13 *Bank. Dev. J.* 509, at 537-40.

19 *Lubrizol*, *supra* note 1, at 1048.

20 Vern Countryman, "Executory Contracts in Bankruptcy: Part II" (1974), 58 *Minn. L. Rev.* 474, at 501.

21 *Ibid.*, at 502. Professor Countryman ultimately classifies intellectual property and technology licensing agreements as executory given that the licensor gives an implied warranty to the licensee as to the validity of the patent or technology and that this undertaking continues for the duration of the licence.

[22] *Intellectual Property Bankruptcy Protection Act*, Pub. L. no. 100-506, 102 Stat. 2538 (codified as amended at 11 U.S.C. §§ 101(52)-(53), 365(n) 1988).

[23] Kopetz, *supra* note 12, at 22.

[24] *Ibid.* Section 365(n)(1) reads as follows:

> If the trustee rejects an executory contract under which the debtor is a licensor of a right to intellectual property the licensee under such a contract may elect—(A) to treat such contract as terminated by such rejection if such rejection by trustee amounts to such a breach as would entitle the licensee to treat such a contract as terminated by virtue of its own terms, applicable non-bankruptcy law, or an agreement made by the licensor with another entity; or (B) to retain its rights (including a right to enforce any exclusivity provision of such contract, but excluding any other right under applicable non-bankruptcy law to specific performance of such contract) under such contract and under any agreement supplementary to such contract, to such intellectual property (including any embodiment of such intellectual property to the extent protected by applicable non-bankruptcy law), as such 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 non-bankruptcy law.

Sections 365(n)(2) and (3) read as follows:

> 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 royalty payments due under such contract for the duration of such contract and for any period described in paragraph 1(B) of this subsection for which the licensee extends such contract; 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 non-bankruptcy law; and (ii) any claim allowable under section 503(b) of this title arising from the performance of such contract.

[25] Both the *Bildisco* and *Lubrizol* decisions explain that the business judgment test is the traditional standard by which to evaluate the trustee's or debtor's decision under s. 365.

[26] Richard M. Cieri and Michelle M. Morgan, "Licensing Intellectual Property and Technology from the Financially–Troubled or Startup Company: Pre-Bankruptcy Strategies to Minimize the Risk in a Licensee's Intellectual Property and Technology Investment" (August 2000), 55 *The Business Lawyer* 1649, at 1665.

[27] *Ibid.*, at 1666.

[28] *Lubrizol*, *supra* note 1, at 1047.

[29] N.M. Wiggins, "The Intellectual Property Bankruptcy Act: The Legislative Response to *Lubrizol Enterprises Inc. v. Richmond Metal Finishers Inc.*," [1990] 16 *Rutgers Computer and Technology L.J.* 603, at 626. Congress's policy consideration with respect to trade-mark agreements dictated that they "depend to a large extent on control of the

quality of the products or services sold by the licensee" and thus it would be best "to allow the development of equitable treatment of this situation by bankruptcy courts."

30 *Re Chipwich Inc.*, 54 Bankr. 427 (S.D. N.Y. 1985).

31 For a discussion on the need for legislative protection of trade-marks see David M. Jenkins, "Licenses, Trademarks, and Bankruptcy, Oh My!: Trademark Licensing and the Perils of Licensor Bankruptcy," [1993] *Intellectual Property Law Review* 207.

32 Wiggins, *supra* note 29, at 628. For the contention that licensee's have abused their new-found rights consult John Musone, *supra* note 18.

33 Wiggins, *supra* note 29, at 628.

34 Houlden and Morawetz, *Bankruptcy and Insolvency Law in Canada*, 3rd ed. (looseleaf) (Toronto: Carswell, 2000), at 3-11.

35 *Bankruptcy and Insolvency Act*, *supra* note 3, ss. 16(3) to 17(2). See also Houlden and Morawetz, *supra* note 34, at 1-66.

36 *Re Bakermaster Foods Ltd.*, (1985), 56 C.B.R. 314 (Ont. S.C.).

37 *Ibid.*, at 315. This proposition was also cited with approval by Justice Halperin in *Malka (Trustee of) v. Tye-Sil Corp.* (1991), 1 C.B.R. (3d) 305 (Que. Sup. Ct.). The court added at 322 that the trustee's obligation to protect the assets of the estate for the benefit of the unsecured creditors is "even more so when the rights of the petitioner are purely personal and there is no 'jus in re.'" The Quebec Court of Appeal affirmed the decision and reasons of Justice Halperin without further comment in *Malka (Syndic de)*, C.A.M. 500-09-001303-908, 1997-01-31 (J.E. 97-385) (C.A.).

38 For example, *In Re Keene*, [1922] Ch. 475. The trustee in bankruptcy wished to sell the goodwill and assets of the debtor's business, but could not do so unless the bankrupt disclosed the secret formulas for the manufacture of the proprietary medicine. The formulas had never been committed to writing. The court forced the debtor to communicate the formulas ruling that they were part of the goodwill and assets of the business. As a result, a patent, trade-mark, or copyright is unnecessary in order to vest all ownership or interest in the intellectual property in a trustee in bankruptcy.

39 *Re Bennett and Bennett* (1988), 67 C.B.R. 314 (B.C. S.C.)

40 The *Re Bennett and Bennett* decision was referred to briefly in *Waryk, Waryk and Waryk v. Bank of Montreal* (1990), 80 C.B.R. (N.S.) 44 (B.C. S.C.). In that case, the commercial fishing licence was issued to a particular fishing boat and not to the bankrupt. The court held that this licence could not constitute property that vested in the trustee because the bankrupt did not have a property interest in the licence.

41 *Electric Chain Company of Canada Limited v. Art Metal Works Inc. and Dominion Art Metal Works Limited*, [1933] S.C.R. 581. B. Sookman, *Computer, Internet and Electronic Commerce Law* (looseleaf) (Toronto: Carswell, 2000), at 2-66.

42 *Heap v. Hartley* (1889), 42 Ch. D. 461 (C.A.), cited in *Electric Chain*, *supra* note 41.

43 *Ibid.*, *Heap v. Hartley*, at 470.

44 Sookman, *supra* note 41, at 2-66. The Supreme Court of Canada in *Compo Co. v. Blue Crest Music Inc.*, [1980] 1 S.C.R. 357; 45 C.P.R. (2d) 1 laid down the principle that rights in intellectual property are rights *in rem* and are conferred by statute. Rights are generally classified as *in personam* or rights *in rem* when relating to property rights.

45 Houlden and Morawetz, *supra* note 34, at 3-11 and 3-12. We point out that the trustee in *Re Frechette* had to respect a positive obligation to sell the debtor's shares.

46 Section 71(2) of the BIA stipulates:

> On a receiving order being made or an assignment being filed with an official receiver, a bankrupt ceases to have any capacity to dispose of or otherwise deal with his property, which shall, subject to this Act and to the rights of secured creditors, forthwith pass to and vest in the trustee named in the receiving order or assignment, and in the case of a change of trustee the property shall pass from trustee to trustee without any conveyance, assignment or transfer.

47 *Re Olympia & York Developments Ltd.* (1995), 34 C.B.R. 93. (Ont. Ct., Gen. Div.).

48 *Stead Lumber Co. Ltd. v. Lewis* (1957), 37 C.B.R. 24 (Nfld. T.D.).

49 *Ibid.*, at 34.

50 *Ibid.* Canadian bankruptcy doctrine also concludes that a common law right to disclaim a contract exists in Canada and cites this passage with approval. Houlden and Morawetz, *supra* note 34, at 3-130.17 discussing contractual rights. In addition, the authors add: "The trustee can disclaim a contract entered into by the bankrupt."

51 *Re Thompson Knitting Co. Ltd.* (1925), 5 C.B.R 489 (Ont. C.A.).

52 *Potato Distributors Inc. v. Eastern Trust Co.* (1955), 35 C.B.R. 161 (P.E.I. C.A.). At 165 the court was careful to indicate that "all the trustee is trying to do by carrying out this contract is to endeavour to mitigate the liabilities as much as possible and not try to make a profit."

53 *Ibid.*, at 166-67. In other words, in the event that the trustee, in upholding the best interests of the unsecured creditors, decides to treat the contract as ongoing, he or she must notify the other party of this decision within a reasonable time. Otherwise, the other party is entitled to treat the contract as broken and not carrying any further obligations. Further authority for this proposition can be found in *Re Thompson Knitting Co. Ltd.*, *supra* note 15, at 490, in *Potato Distributors Inc.* and in Houlden and Morawetz, *supra* note 34, at 3-130.17.

54 *Re Erin Features #1 Ltd.* (1991), 8 C.B.R. (3d) 205 (B.C. S.C.).

55 *Ibid.*, at 206.

56 *Ibid.*, at 207.

57 "Case Comment," *Re Erin Features #1 Ltd.* (1993), 15 C.B.R. (3d) 66.

58 *Ibid.*, at 71.

[59] For example, see *Re Bakermaster Foods Ltd.* (sale of land), *Stead Lumber Co.* (contract of personal nature—mechanic's lien), and *Malka (Trustee of) v. Tye-Sil Corp.* (option to purchase immovable property) discussed earlier in this article.

[60] *Re Erin Features #1 Ltd*: Case Comment, *supra* note 57, at 72. See also *Driedger on the Construction of Statutes*, 3rd ed. (Toronto: Butterworths, 1994) by Ruth Sullivan, at 298 and following. See also *Gendron v. Supply & Services Union of the Public Service of Canada, Loc. 50057*, [1990] 1 S.C.R. 1298, at 1317 and 1319.

[61] In contrast to the positive covenant to sell shares in *Re Frechette*. Professor Gold describes the distinction as follows:

> The fact that a licence is to a negative covenant as opposed to a positive covenant, such as an obligation to provide a specific service or to deliver a load of widgets to a pier, is significant when it comes to enforcement of the licence. The general rule is that courts will not enforce positive covenants through specific performance; that is, courts are wary of ordering someone to take affirmative steps, preferring damages as a remedy. When it comes to negative covenants—covenants to refrain from acting—courts are much more sympathetic to ordering specific performance.

Richard E. Gold, "Partial Copyright Assignments: Safeguarding Software Licensees Against the Bankruptcy of Licensors" (2000), 33 *Can. Bus. J.* 193, at 205.

[62] *Re Erin Features #1 Ltd.*: Case Comment, *supra* note 57, at 74. These arguments are reiterated in Wendy A. Adams and Gabor G.S. Takach, "Insecure Transactions: Deficiencies in the Treatment of Technology Licences in Commercial Transactions Involving Secured Debt or Bankruptcy" (2000), 33 *Can. Bus. L.J.* 321. The view that Canadian courts are unlikely to allow a debtor to terminate a licensing agreement in the absence of a general right to reject executory contracts is also shared by Professor Marvin Baer, "Contact Rights in Insolvencies," published on June 1, 2001 at http://strategis.ic.gc.ca/SSG/cl00277e.html.

[63] Adams and Takach, *ibid.* The article concludes:

> The solution preferred by the authors is that of a legislative amendment whereby licensees may elect to retain their rights under rejected contracts so long as the required royalty payments are maintained.

This legislative approach is also favoured by Professor Michael Geist:

> Resolving the uncertainty that surrounds technology licences upon licensor's bankruptcy requires legislative reform. Non-legislative solutions depend on the vagaries of contractual drafting and court interpretations therefore making them unsatisfactory. In approaching a legislative solution, it is necessary to balance the conflicting interests of the bankrupt, secured debtors, unsecured debtors and licensees. Legislative reform that secures the rights of licensees who obtain licences in the normal course of business is preferable, since it creates commercial certainty and brings the Canadian approach into line with that of the United States.

Michael Geist, *When Dot-Coms Die: The E-commerce Challenge to Canada's Bankruptcy Law* (Ottawa: Industry Canada, Centre for Innovation Law & Policy, forthcoming), at 22. In addition, the amendments to the BIA in 1992 brought it more in line with the U.S. *Bankruptcy Code*, making American jurisprudence and authorities in bankruptcy matters of assistance in interpreting the BIA; Houlden and Morawetz, *supra* note 34, at 1-5.

64 George S. Takach, *Computer Law* (Toronto: Irwin Law, 1998), at 319. See also Kopetz, *supra* note 12, at 22.

65 *Ibid.*, Takach, *Computer Law*, at 319.

66 *Ibid.*

67 From this premise, George Takach posits that courts in Canada would be more likely to follow the decision in the *Erin Features* case and not *Lubrizol*. "Thus, a court in Canada, if faced with the question whether a trustee in bankruptcy can disclaim the software licences granted prior to the bankruptcy of a Canadian software company, may not follow the *Lubrizol* case and instead might follow the decision in the *Erin Features* case." *Ibid.*

68 *Driedger on the Construction of Statutes*, *supra* note 60:

> It follows from the principle of legislative sovereignty that validly enacted legislation is paramount over the common law. … It means that the courts are bound to give effect to the purpose and meaning of legislation, regardless of its impact on the common law. … It also means that once the legislature indicates expressly or by implication that it has dealt with a matter fully to its own satisfaction, it is impermissible to vary or add to the legislation by resorting to the common law. This principle applies to both the substantive and procedural law.

See also *Gendron*, *supra* note 60, at 1317 and 1319

69 Houlden and Morawetz, *supra* note 34, at 1-1.

70 *Bankruptcy Act*, 1869 (32 & 33 Vict.), c. 71. Section 23 of the 1869 Act gave the trustee the power to "disclaim" the contract of a bankrupt. See *In Re Sneezum. Ex parte Davis*, 3 Ch. D. 463 (C.A.). The modern day statute confers the same right upon the trustee: *Insolvency Act* 1986 (U.K.), 1986, c. 45, s. 315.

Section 315 of the *Insolvency Act, 1986* (disclaimer of onerous property), reads as follows:

> 315.(1) Subject as follows, the trustee may, by the giving of the prescribed notice, disclaim any onerous property and may do so notwithstanding that he has taken possession of it, endeavoured to sell it or otherwise exercised rights of ownership in relation to it.
>
> (2) The following is onerous property for the purposes of this section, that is to say—(a) any unprofitable contract, and (b) any other property comprised in the bankrupt's estate which is unsaleable or not readily saleable, or is such that it may give rise to a liability to pay money or perform any other onerous act.

71 Section 30(1)(k) of the Canadian *Bankruptcy and Insolvency Act*, *supra* note 3, corresponds to the unexpired lease portion of s. 365(a) of the U.S. *Bankruptcy Code*. Section 30(1)(k) provides as follows:

> The trustee may, with the permission of the inspectors, do all or any of the following things … (k) elect to retain for the whole part of its unexpired term, or to assign, surrender, disclaim any lease of, or other temporary interest in, any property of the bankrupt.

72 *Re Palais des Sports de Montréal Ltée.*; *Hamel v. Samson*, [1960] Q.B. 1012; 1 C.B.R. (N.S.) 260, the Quebec Court of Appeal held that section 30(1)(k) does not give the trustee the right to cancel a lease entered into by a debtor prior to bankruptcy in respect of the premises owned by the debtor. In the opinion of the court the subsection only applies to cases where the bankrupt is the lessee, not where he is the lessor.

73 Not to be confused with Gabor G.S. Takach, the co-author of the Case Comment on *Re Erin Features #1 Ltd.*, *supra* note 57 and Adams and Takach, *supra* note 62.

74 Takach, *Computer Law*, *supra* note 64, at 320.

75 *In Re O.T.E.A. Inc.: Banque Royale du Canada v. Béliveau*, [1976] C.A. 539. In the words of the Quebec Court of Appeal, at 541:

> Rien dans la *Loi sur la faillite* n'oblige un syndic à assumer une obligation de faire ou toute autre obligation onéreuse que le failli, avant sa faillite, s'était obligé à accomplir, sauf à prendre, le cas échéant, les mesures conservatoires qui s'imposent (art. 12(7) et 13(1)). Si le contrat constitue un bien (art. 2, "biens," c'est-à-dire qu'il comporte au stade où il est rendu aussi des avantages, des droits, le syndic a la faculté) et le créancier d'une telle obligation est lié par le choix (que fera le syndic) de retenir le contrat pour y donner suite ou d'en disposer comme tout autre bien (art. 14(1)k)). Le "bien" alors ne consiste que dans les droits que le failli possédait encore dans ce contrat au jour de sa faillite; le syndic ne peut avoir (sauf exceptions spécfiquement prévues, v.g. le recours paulien) plus de droits dans un bien que n'en avait le failli.
>
> Le syndic ne pouvait obtenir contre le gré de locataire la résiliation du bail, mais cela ne veut pas dire qu'il était tenu d'accomplir les obligations du locateur.

76 *Coopérants, Mutual Life Insurance Society (Liquidator of) v. Dubois*, [1996] 1 S.C.R. 900.

77 *Ibid.*, at 916-17. The court concluded at 917 that the undivided co-owner

> made commitments in a context of continuity over time and reciprocity and has fulfilled and is offering to fulfil his obligations. The obligations involved are comparable in a number of respects to those under a lease of an immovable granted by the insolvent owner thereof. It has been recognized that such a lease may be set up even against a trustee in bankruptcy (*McCarter*, *supra*; *Brault v. Langlois*, [1954] B.R. 41; and *In re Palais des Sports de Montréal Ltée*, [1960] B.R. 1012). It is advisable to respect such contracts and ensure that they are as stable as possible.

78 *Ibid.*, at 918. The Supreme Court concluded that no circumstances requiring equitable relief were present in the *Coopérants* case:

> In the absence of such evidence, which would permit a comparison between the price payable under the agreements and the market value in undivided co-ownership of the debtor's shares, it cannot be concluded that complying with the mandatory sale clauses in the indivision agreements would harm the other creditors.

79 *Re Sonne Awnings Ltd.* (1925), 7 C.B.R. 38 (Que. Sup. Ct.).

80 The relevant paragraphs of s. 83 of the BIA for the purposes of our discussion are the following:

> (1) Notwithstanding anything in this Act or in any other statute, the author's manuscripts and any copyright or any interest in a copyright in whole or in part assigned to a publisher, printer, firm or person becoming bankrupt shall, (a) if the work covered by the copyright has not been published and put on the market at the time of the bankruptcy and no expense has been incurred in connection therewith, revert and be delivered to the author or his heirs, and any contract or agreement between shall then terminate and be void; (b) if the work covered by the copyright has in whole or in part been put into type and expenses have been incurred by the bankrupt, revert and be delivered to the author on payment of the expenses shall also be delivered to the author or his heirs and any contract or agreement between the author or his heirs and the bankrupt shall then terminate and be void, but if the author does not exercise his rights under this paragraph within six months of the date of the bankruptcy, the trustee may carry out the original contract; or (c) if the trustee at the expiration of six months from the date of the bankruptcy decides not to carry out the contract, revert without expense to the author or his heirs and the bankrupt shall then terminate and be void.
>
> (2) Where, at the time of the bankruptcy referred to in subsection (1), the work was published and put on the market, the trustee is entitled to sell, or authorize the sale or reproduction of, any copies of the published work, or to perform or authorize the performance of the work, but (a) there shall be paid to the author or his heirs such sums by way of royalties or share of the profits as would have been payable by the bankrupt; (b) the trustee is not, without the written consent of the author or his heirs, entitled to assign the copyright or transfer the interest or to grant any interest therein by licence or otherwise, except on terms that will guarantee to the author or his heirs payment by way of royalties or share of the profits at a rate not less than the rate the bankrupt was liable to pay and (c) any contract or agreement between the author or his heirs and the bankrupt shall then terminate and be void, except with respect to the disposal, under this subsection, of copies of the work published and put on the market before the bankruptcy.

81 *Re Groupe Morrow Inc.* (1992), 22 C.B.R. (3d) 195; [1993] R.J.Q. 161 (C.S.).

82 In the United States, the Ninth Circuit Bankruptcy Appellate Panel in *Encino Business Management, Inc. v. Prize Frize, Inc. (In Re Prize Frize, Inc.)*, 150 B.R. 456, at 459

(Bankr. 9th Cir. 1993), determined that the term "royalty payments" must be defined broadly to include any payment for the use of intellectual property, no matter how the payment is designated in the contract. For a further discussion on this issue see Kopetz, *supra* note 12, at 23-25.

83 *Re Groupe Morrow Inc.*, *supra* note 81, at 202 (C.B.R.).

84 Section 83 refers to the bankrupt's obligations to pay the author and to the trustee's obligation to protect the author's royalty payments.

85 Section 65.1:

> (1) Where a notice of intention or a proposal has been filed in respect of an insolvent person, no person may terminate or amend any agreement with the insolvent person, by reason only that
>
> (a) the insolvent person is insolvent; or
>
> (b) a notice of intention or a proposal has been filed in respect of the insolvent person;
>
> (2) Where the agreement referred to in subsection (1) is a lease or a licensing agreement, subsection (1) shall be read as including the following paragraph: …
>
> (c) the insolvent person has not paid rent or royalties, as the case may be, or other payments of a similar nature, in respect of a period preceding the filing of
>
> (i) the notice of intention, if one was filed, or
>
> (ii) the proposal, if notice of intention was filed.

86 Ellen L. Hayes, "Executory Contracts in Debt Restructuring" (1994-95), 24 *Can. Bus. J.* 44, at 56. See also Jonathan E. Fleisher, "Intellectual Property Rights and Bankruptcy" (July 1990), 7 *Bus. & L.* 50.

87 *Ibid.*, Fleisher, at 58. Section 65.1(6) of the BIA.

88 Sookman, *supra* note 41, at 2-45. See also C.I. Kyer, "Intellectual Property Assets in Insolvency" (June 1991), 8 *Bus. & L.* 45.

89 Sookman, *supra* note 41, at 2-47 and 2-48.

90 Moody, *supra* note 2, at 112.

91 *Ibid.*

92 Sookman, *supra* note 41, at 2-51. See also Hugh Laurence, "Software Escrow Agreements" (1984), 1(11) *Can. Computer L.R.* 209.

93 Cieri and Morgan, *supra* note 26, at 1680.

94 Sookman, *supra* note 41, at 2-51.

95 Gold, *supra* note 61, at 218.