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Strategies Relating to the US Bankruptcy Laws and Information Technology

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There are many issues that arise in connection with drafting, negotiating, and enforcing license terms and conditions respecting bankruptcy and related source code escrow provisions. This article focuses on §365(n) of the US Bankruptcy Code and several other sections of the US Bankruptcy Code that most affect information technology transactions, source code escrow agreements and strategies, and issues relating to the perfection of security interests in intellectual property and information technology under US law.

First, we will discuss §365(n) of the US Bankruptcy Code and a number of strategies that have arisen in connection with §365(n). Then, we will discuss specific concerns arising in connection with §365(c) and the automatic stay provisions under the US Bankruptcy laws. Next, we will discuss source code escrow agreements and strategies related to licensees obtaining access to source code. Last, we will discuss the perfection of security interests in information technology intellectual property assets and the assignment of intellectual property assets in bankruptcy.

Intellectual Property Bankruptcy Protection Act

The Intellectual Property Bankruptcy Protection Act (Public Law 100-506) was enacted October 18, 1988. It represents a significant development affecting software licensors and licensees and other intellectual property licensors and licensees. Information technology and intellectual property legal practitioners must have a thorough understanding of these Intellectual Property Bankruptcy Protection Act amendments to the US Bankruptcy Code.

The Intellectual Property Bankruptcy Protection Act added a new subsection (n) to §365 of the US Bankruptcy Code and also added several new definitions to §101.[1] Under US bankruptcy law, debtor licensors may reject a license in their bankruptcy proceeding on the ground that meeting their obligations under the license agreement constitutes too great a burden on the bankruptcy estate. A debtor's right to assume or reject an executory contract is vital to the basic purpose of a Chapter 11 reorganization under the Bankruptcy Act.[2]

Under §365 of the US Bankruptcy Code, a debtor licensor has the right to reject "executory contracts." The §365 power to assume or reject a license is limited to executory contracts. An executory contract is any agreement that contains materially unperformed obligations respecting both parties when the failure to perform would constitute a material breach.[3] Most software licenses are executory contracts because the licensee has obligations to pay license fees, maintain confidentiality of the software, use the software appropriately, or other material obligations and the licensor has obligations such as indemnification and software maintenance and support. A contract that is not executory or a sale is not subject to rejection.

Section 365(n) provides a licensee with two options: treat the rejection of the license as a material breach under §365(n)(1)(A) and terminate the license agreement or elect to retain its license under §365(n)(1)(B) with certain modifications. Under the first option, the licensee loses its license to the software but obtains a general unsecured claim for money damages under §365(g) of the Bankruptcy Code. Generally, under this first option, licensees receive very little as unsecured creditors and lose the right to continue using the licensed software. The licensee would be in the same position as any other party whose contract was rejected and treated as a general unsecured creditor with a prepetition claim. Under the second option, the licensee retains a license with the same rights that existed on the date that the bankruptcy petition was filed, but all future obligations on the licensor (such as indemnity, new developments, maintenance and support) are terminated, though the licensee is obligated to continue paying license fees to the extent provided in the license. As such, it is very important that the licensee ensure that it has sufficient rights under the license as of the date that the bankruptcy petition was filed to continue using the licensed software. There are many interesting strategies on how §365(n) may be used, which will be discussed below.

The Intellectual Property Bankruptcy Protection Act seeks to ensure that a licensee of intellectual property receives the benefit of its bargain, even after the licensor's bankruptcy. Section 365(n) grants a new, statutorily defined license. "Intellectual property" is defined in the Bankruptcy Code to include mask works, copyrights, and patents arising under specific sections of US law as well as patent applications and trade secrets without any geographic distinction.[4] Trademarks are expressly excluded. This exclusion may prove especially troublesome in connection with software distribution licenses in which the distributor licensee is distributing a trademarked software product. There is also a concern with copyrights and patents arising under foreign laws because the definition of intellectual property in the Bankruptcy Code does not appear to include copyrights and patents under foreign laws.

If the licensee elects to retain its rights under the license agreement under §365(n), it must continue to make royalty payments under the license agreement. If a licensee elects to retain the right to use the licensed software, it must waive any right of setoff that it may have for damages resulting from the rejection and any priority claim that the licensee may have as a result of its performance under the license. More particularly, under these amendments, the licensor is prohibited from interfering with the licensee's exercise of its retained rights. But in the event of licensor's rejection, the licensor is relieved of its affirmative obligations under the license to include duties such as maintenance, training support, providing enhancements or new releases, warranty obligations, and indemnification obligations. As such, even with access to the source code, the licensee's continuing rights to use the software may not be sufficient because the licensee may not be able to maintain and support the software without the licensor's assistance. The risks require licensees to assess §365(n) and related source code escrow strategies.

Because licensees under §365(n) only retain the rights that exist at the time of licensor's bankruptcy, licensees should ensure that the license agreement expressly includes source code and maintenance rights within its scope. The important concept is that you cannot retain rights you never had. We recommend including a current license to the source code corresponding to the licensed software subject to a subsequent future condition based on the conditions for obtaining access to source code. This is in essence a license to use a future interest.[5] We further believe that this license to source code should include the right to copy, adapt, and modify the source code for licensee's internal use and support consistent with licensee's license agreement even though the rights are not triggered until the source code license commences. The future condition subsequent could be tied to obtaining access to the source code held for licensee's protection under a source code escrow arrangement or other event or combination of events.

License provisions that require delivery of source code, technical documentation, or other intellectual property in the event of the licensor's bankruptcy are enforceable under these Intellectual Property Bankruptcy Protection Act amendments. Thus, even if the license agreement provides for source code delivery after bankruptcy, the licensee can require the source code to be delivered to it. If the source code was not delivered, the licensee should be able to enforce those delivery rights in the bankruptcy court having jurisdiction over the debtor licensor.

Another important right under the Intellectual Property Bankruptcy Protection Act concerns the period after bankruptcy but prior to the licensor's rejection decision. Upon written request of the licensee, the licensor can be made to perform its obligations under the license agreement.

It should be pointed out that the Intellectual Property Bankruptcy Protection Act does not address the situation of a bankrupt licensee. A debtor-licensee of intellectual property may continue to reject an executor contract and, in such case, return the licensed intellectual property to the licensor.

Below we will discuss how a licensee can protect itself in the event that the licensor does not consent to a confirmation of the license agreement by the licensee, that is, the licensor rejects the license.

License agreements need to contemplate specifically the post-bankruptcy rights that the licensee may retain. The continuing obligations of the licensee that survive the licensor's bankruptcy rights need to be detailed. For example, it may be appropriate to adjust the payment terms to reflect the responsibilities of the parties in the event that the licensee elects to retain the licensed software and related source code. Typically, license fees, renewal fees, maintenance fees, and so forth implicitly include royalties for the use of the licensed intellectual property, but the royalties are not expressly denominated as such. Licensors need to ensure a continuing revenue stream from the retaining licensee. It is recommended that license agreements reflect the royalty payments that the licensee has to pay the licensor in such a situation in which the licensee is granted the right to retain the licensed software albeit without any licensor support. This is because, if the licensor is not providing maintenance, then there would probably be no continuing obligation to pay the licensor for the retained use of the software and related source code if the licensee's only existing obligation, for example, was to pay maintenance fees.

Below is an example of this type of provision:

If the Licensor rejects the License Agreement under Section 365(n) of the Bankruptcy Code, the Licensee may elect to (i) treat the Agreement as terminated pursuant to Section XXX (Termination) of this License Agreement or (ii) retain Licensee's rights under the License Agreement, including, without limitation, the right and license to use, adapt and modify the Licensed Software and related Source Code for the full term of the License Agreement and obtain a complete and current copy of the source code corresponding to the licensed software used by Licensee from the Source Code Escrow Agent or, in the event a complete and current copy of the Source Code is not provided to the Source Code Escrow Agent, then directly from Licensor.

In consideration of obtaining a copy of the Source Code under the provisions of this Agreement, Licensee agrees to pay Licensor, in lieu of any other fees, an annual royalty in the amount of $______ commencing upon Licensor's receipt of the Source Code and continually thereafter on the anniversary of such receipt for as long as Licensee continues to use the Licensed Software, or any derivative thereof.

The royalty payment will differ from situation to situation. If the licensor is not providing any maintenance and support, we believe that the royalty should be substantially less than 50 percent of what would otherwise have been the licensee's annual maintenance fee obligation. An annual royalty of between 10 percent and 20 percent of the annual maintenance fee obligation is likely to be reasonable in most circumstances.

Section 365(n) of the Bankruptcy Code requires careful planning and drafting. In this article we will address a number of the risks and issues that may arise in connection with §365(n). First, we will address specific cases and strategies related to §365(n) and then §365(c) and then discuss various source code escrow strategies and the perfection of security interests.

Specific §365(n) Cases and Strategies

Avoiding Liquidated Damages and Foreign Governing Law *In re: EI International*[6] was the first court ruling applying the 1988 Intellectual Property Bankruptcy Protection Act amendments. The ruling shows how §365(n) may be used to avoid the imposition of liquidated damages or other damages and the application of foreign law under a governing law provision in the executory contract.

In this case, EI International had agreed to supply its PMAX software system to Ontario Hydro, a Canadian public utility corporation, as customized to meet Ontario Hydro's requirements. After EI International filed its Chapter II bankruptcy petition, EI International rejected its executory contract with Ontario Hydro under §365 of the US Bankruptcy Code.

Ontario Hydro claimed $3,631,533 in contract damages, mostly to correct deficiencies and omissions to make good the delivered software. EI International acknowledged Ontario Hydro's claim only to the extent of $176,752.00. Even though the contract in question included a governing law clause requiring Ontario law, the US Bankruptcy Court held that US bankruptcy law governed the dispute in the bankruptcy court. As such, §365(n) may be viewed as a strategy for avoiding the application of foreign law under limited circumstances. If the licensor files for bankruptcy protection in the United States, the US bankruptcy law will apply to any contracts with foreign parties.

Under the circumstances, the Bankruptcy Court concluded that Ontario Hydro's claim should be treated like any other claim resulting from a rejected executory contract under §365. The rejection of an executory contract under §365 rejects the entire contract, including the damages provisions. Therefore, the liquidated damages provision in the contract was determined to be not enforceable because "if liquidated damage clauses were enforceable, there would be no reason for rejection of the contract by a debtor." Since Ontario Hydro elected to retain the software rather than treat the rejection as a termination, Ontario Hydro was deemed to waive any right of set-off and any post-petition contract claims. Therefore, the Bankruptcy Court ruled that Ontario Hydro was entitled only to the damages that it would have sustained as a pre-petition claim for breach of the contract by EI International. Ontario Hydro's allowable claim was thus limited to its actual "out of pocket costs," which Ontario Hydro had sustained prior to the filing of EI International's Chapter 11 petition. Accordingly, §365(n) can also be used as a strategy for limiting damages and remedial obligations. This strategy, for example, could be useful in connection with a failed software development project in which the licensor is facing significant potential money damages and performance obligations.

Section 365(n) Can Be Used By Licensors as a Collection Strategy *Encino Business Mgmt. v. Prize Frize, Inc.*,[7] does not involve information technology, however, it is a very important bankruptcy ruling on whether license fees paid by a licensee for the use of technology, patents, and proprietary rights are "royalties" within the meaning of 11 U.S.C. §365(n)(2)(B) and, as such, must therefore continue to be paid after the licensor in bankruptcy has exercised its statutory right to reject the contract. Royalty payments are not defined in the Bankruptcy Code, but the legislative history and this court ruling suggest that whether a payment should be considered a "royalty" should depend on the substance of the transaction and not on the label. This situation is an invitation for disputes requiring specific reference to "royalty payments."

Under the license, the licensee agreed to pay the licensor a license fee of $1,250,000, which was to be paid as follows: $300,000 at execution and then $50,000 per month until the balance was paid. The licensor filed for bankruptcy protection under Chapter 11. The licensee stopped making the monthly license fee payments on the ground that there was a design defect in the technology. The debtor licensor then filed to reject the license agreement and to compel the licensee to elect whether it wished to retain its rights under §365(n)(1). The bankruptcy court ordered that, in the event that the licensee elected to retain its rights under the agreement pursuant to §365(n)(1), it must pay all license fees currently due, pay the balance in monthly installments, and waive any and all rights to set-off with respect to the contract under applicable non-bankruptcy law and any claim under §503(b) of the Bankruptcy Code arising from performance under the agreement.

When the licensee elected to retain its rights, it was then obligated to make all royalty payments due under the contract. The licensee argued that the license agreement distinguished between royalties and license payments and that the license fees are not royalty payments that must be paid in the event of retention. The bankruptcy court noted that §365(n) speaks repeatedly of "licensor" and "licensee" with the clear implication that payments by licensee to licensor for the use of intellectual property were "licensing fees" or "royalties" and, as royalties, must be paid by the licensee that elects to keep its license after the licensor's bankruptcy. The court raised the question of whether an allocation would have been proper in view of licensor's other contract obligations for which it was no longer responsible; however, the issue was not raised by the parties and therefore not considered in the ruling. This court ruling supports our recommended allocation and specification of the "royalty payments."

The *Encino* case suggests how §365(n) may be used to collect license fees and royalties. For example, assume that the licensor is a very small company or otherwise unable to fund a legal collection lawsuit. The licensee asserts grounds, whether real or just a pretense, for not paying the licensor license fees that are otherwise due. The licensee knows that the licensor is experiencing financial problems and does not have the wherewithal to commence a collection lawsuit against the licensee. The licensor can use §365(n) and the bankruptcy court to collect the licensee's debt to the licensor to the extent the licensee elects to retain the licensed intellectual property.

Section 365(n) Can Affect the Timing and Strategy for Acquiring IP Assets in a Bankruptcy Proceeding The ruling in *Schlumberger Resource Management Services, Inc. v. CellNet Data Systems, Inc.*,[8] provides a number of valuable lessons respecting the purchase of intellectual property assets in a bankruptcy proceeding, including any license agreements relating to the intellectual property assets.

CellNet Data Systems had a license agreement with BCN Data Systems. Under the license agreement, CellNet received a royalty equal to 3 percent of BCN's gross revenues from CellNet's technology. CellNet sold its intellectual property assets to Schlumberger while CellNet was in bankruptcy. Schlumberger excluded the BCN license agreement and other CellNet license agreements from the intellectual property assets that Schlumberger acquired from CellNet. This purchase effectively severed the license agreements from the intellectual property assets that Schlumberger acquired. Following Schlumberger's purchase, CellNet rejected the license agreements with BCN as part of its bankruptcy proceeding.

After CellNet rejected its BCN license agreement, BCN elected to retain its rights under §365(n). Under §365(n) BCN was required to make all royalty payments due under the contract for the duration of the contract. By its election under

§365(n), BCN was permitted to continue to use the licensed intellectual property originally licensed from CellNet but was required to pay the royalties due under the license agreement. Even though Schlumberger had acquired CellNet's intellectual property assets in the bankruptcy proceeding, Schlumberger was not entitled to the royalties related to the license agreement assets that had been excluded from the assets that Schlumberger had acquired from CellNet. BCN paid the royalties to the debtor CellNet rather than to Schlumberger.

It appears that neither Schlumberger nor CellNet fully appreciated the potential risk that BCN might elect to retain the licensed technology under §365(n) subject to the terms of the CellNet license agreement that CellNet rejected. This result speaks to the need for carefully analyzing the risks of §365(n). For example, it may have been more prudent to acquire the license agreements as part of the acquisition in the bankruptcy proceeding then terminate the license agreements after the acquisition closed to the extent that the termination provisions permitted such termination. This may not have been possible, but it is the type of analysis that should have been conducted.

Must Recognize That Trademark Rights Are Not Covered By §365(n) The bankruptcy court in *In re Centura Software Corporation*[9] granted the debtor's and creditor committee's motion for partial summary judgment on the ground that §365(n) of the Bankruptcy Code does not protect the licensee's rights to use the debtor's trademarks.

The bankruptcy court concluded that once a license has been rejected the counter-party may not continue to use the trademarks. Raima UK sought to continue to market and sell software products under trademarks owned by the debtor, Centura Software Corporation. Raima UK also sought software updates and documentation. Under §365, if a contract is rejected, the debtor is deemed to have breached it, and the bankrupt estate loses any benefit from the contract. Raima UK selected to retain its protected rights to market and sell Raima software. Since §365(n) does not extend to trademarks, however, Raima UK is left with a §365(g) claim for damages resulting from being unable to use the trademarks in its business. The court determined that Congress had unambiguously indicated that trademark licenses are to be excluded from §365(n). Raima Software lost its trademark rights but is entitled to file an unsecured pre-petition claim for damages resulting from not being able to use such trademarks. The court also denied Raima any post-petition performance respecting enhancements because, as the result of the election to retain the distribution license, Centura Software had no obligation to support the licensee.

The fact that §365(n) does not include trademarks may prove extremely important. For example, assume that your client has an exclusive trademark license that is critical to your client's business plans. The licensor experiences significant financial difficulties. Four petitioners file an involuntary bankruptcy proceeding against the licensor. If the involuntary bankruptcy proceeding goes forward, there is a significant risk that the licensor will reject the exclusive license and the licensee will lose its trademark rights notwithstanding already having paid the licensor millions of dollars. Under these circumstances, the licensee is likely to determine that it is compelled to acquire the trademark rights from the licensor. The purchase price was based on satisfying the licensor's creditors to avoid any liens being filed against the trademark assets and otherwise have the involuntary bankruptcy proceeding against the licensor dismissed. Section 365(n) can require strategies like this to be implemented.

Strategies Related to §365(c) of the US Bankruptcy Code

Is a software license assumable by a licensee in the event the licensee seeks bankruptcy protection? The risk of non-assumption may prove quite significant.

The *In re Sunterra Corp.* Ruling The importance of the assumption question respecting software licenses to debtor licensees was emphasized by *In re Sunterra Corporation (RCI Technology Corp. v. Sunterra Corp.)*[10] There, the

Fourth Circuit reversed the district court by holding that the debtor-in-bankruptcy did not have the right to assume the RCI software license in question without the software licensor's consent. We have never seen this risk addressed in any software license. As such, this ruling may prove very significant because it raises the need for new contract protection to address this "assumption" risk.

In the *Sunterra* case, the Fourth Circuit found that §365(c) of the Bankruptcy Code did not permit Sunterra, the debtor licensee, to assume its nonexclusive software license with RCI without RCI's consent to the assumption. Sunterra was precluded from assuming its RCI software license to use and modify RCI's Premier Software. Under the RCI software license agreement, Sunterra owned any "enhancements" and granted RCI a license to use the Sunterra enhancements. Sunterra had invested millions of dollars in the Premier Software. Under the circumstances, the RCI software license had become critical to Sunterra's operations; however, its ability to assume the license as part of its plan to exit its bankruptcy depended on the licensor's consent.

In the *Sunterra* bankruptcy proceeding, RCI filed a motion with the bankruptcy court to deem its license with Sunterra rejected, and RCI asserted further that, since it had refused to consent to the assumption of the license agreement, the court was required by law to deem the license rejected.

In ruling against Sunterra and its intent to assume the RCI license, the Fourth Circuit followed the "literal test" applicable to the interpretation and application of §365(c) of the Bankruptcy Code. The literal test provides that a debtor-in-possession may not assume an executory contract over a non-debtor's objection if applicable law (*e.g.*, the copyright laws) would bar assignment to a hypothetical third party. This prohibition applies even when the debtor-in-possession has no intention of assigning the contract in question to any third party. Software licenses are copyright licenses. Copyright law prohibits the assignment of a copyright license without the consent of the copyright holder licensor. As such,

§365(c) places the licensee at risk if the licensee ever seeks to assume a particular software license in a bankruptcy proceeding. The assumption option might not be available to the licensee.

The Fourth Circuit determined that the RCI software license was an executory agreement. In so ruling, the Fourth Circuit applied the *Countryman* test and found that the RCI software license was executory at the time that Sunterra applied for bankruptcy protection because each party owed at least one continuing material duty to the other under the agreement. In particular, the parties each possessed an ongoing obligation to maintain the confidentiality of the source code of the software developed by the other. As such, the Fourth Circuit found that §365(c), under the literal test, prohibits Sunterra from assuming the RCI license agreement without RCI's consent.

Under §365(c), the Fourth Circuit considers "assumption" and "assignment" in connection with an executory software license to be independent acts, both of which require the licensor's consent.

Managing the Non-Assumption Risk The non-assumption of a software license in a bankruptcy is likely to be a very rare event. In view of the catastrophic consequences in the event of such a non-assumption, however, consideration needs to be given to managing the assumption risk.

The non-assumption risk should be manageable by a contract provision.[11] Below is a simple provision dealing with the non-assumption risk.

Assumption. Notwithstanding any provision to the contrary, in the event Licensee declares bankruptcy and elects to assume this License Agreement in the bankruptcy proceeding, Licensor hereby consents to such assumption by Licensee provided Licensee agrees to comply with all of the terms and conditions of the License Agreement.

This provision starts with the proverbial "notwithstanding any provision to the contrary" because most license agreements provide for termination in the event of bankruptcy even though such provisions are *ipso facto* invalid and unenforceable pursuant to §365(e) of the Bankruptcy Code.[12] The licensor's consent to an assumption occurs only if the licensee makes the decision to assume the license. The provision does not obligate the licensee to assume the license. In most bankruptcy situations, it is likely that the licensee will reject most software licenses; however, there is a contingent risk respecting assumption for which the licensee should seek protection.

The *Sunterra* ruling underscores the potential importance of the assumption decision to software licensees in bankruptcy proceedings. Software licensees need to contemplate the risk of non-assumption and in some situations should seek to manage the risk by including a contract provision that obtains the licensor's advance consent to the licensee's assumption of the license agreement in the event that the licensee makes the decision to assume the license during a bankruptcy proceeding.

Source Code Escrow Agreements

The purpose of source code escrow arrangements is to have a current and complete copy of the source code corresponding to the licensed software in safekeeping for the benefit of the licensee in the event that the licensor ceases business operations or is no longer able to maintain and support the licensed software. The source code escrow arrangements should be designed to permit the licensee to take over the licensor's support obligations. In addition to obtaining access to the source code, there are a number of other strategies that may be implemented to place the licensee in as strong a position as possible if the licensor fails or is otherwise unable to support the licensed software.

Possession of source code is essential to software licensees that intend to modify the software. Licensees without a current intention to make software modifications, however, often regard source code as a necessary form of insurance against a situation in which they are unable to continue using the software because the licensor is unable or unwilling to correct errors or otherwise support the product. Possession of the source code, customers believe, will enable them to step into the breach and keep the system up and running.

Because the uses that can be made of source code (*e.g.*, modifying software and discerning proprietary vendor algorithms and other trade secrets) are fundamentally different from uses ordinarily made of object code (data processing), any licensor that makes source code available to a licensee should include in its license agreement a provision that carefully and precisely defines the specific rights in the source code that the licensee is permitted to exercise. For example, the licensor may wish to permit the licensee to use only the single copy of source code provided and to prohibit the licensee from making hard copies or electronic copies for other than machine use and archival purposes. As noted earlier, the licensor may wish to authorize only certain types of modifications to the software and to prohibit all other modifications. It is fairly common to limit changes to those necessary to maintain and support the software internally. In almost all circumstances, the licensor will wish to prohibit disclosure and distribution of source code. In no event should source code be provided under a license agreement that gives the licensee sweeping rights "to use the software" without making special provision for source code and the scope of license applicable to the source code.

Licensors that do not routinely make source code available to their licensees are often prepared to respond to licensee requests to deposit source code into an escrow for the licensee's benefit and protection. A source code escrow is an arrangement by which the licensor places source code in the hands of an independent third party for safekeeping. Then, in the event of the occurrence of anyone of a number of enumerated events, such as the licensor's business cessation or discontinuance of support for a product line, the licensee is entitled to receive a copy of the source code. The user should seek to ensure that the source code and all other information that the user will need to maintain the software itself are deposited into escrow. The following issues generally arise in connection with creating a source code escrow.

Escrow Agent Selection The parties must select an escrow agent. A number of companies are in the source code escrow business and are equipped to maintain source code on electronic media in a secure, controlled environment. Many large licensors have established source code escrows and merely need to notify the escrow agent of additional beneficiaries as they get new licensees.

Payment of Fees The parties must allocate responsibility for payment of the costs of the escrow. Typical costs include an initial setup fee, an annual maintenance fee, and fees in connection with individual transactions such as deposits and withdrawals. The failure to pay the escrow fees on an ongoing basis is the most common reason for escrow arrangements to fall apart. One way to address this problem is for the licensee to have the right to pay the escrow fees and credit such payment against any other fees due to the licensor. To do this, the licensee should seek to be in contractual privity with the escrow agent and receive notice of nonpayment.

Code Verification The licensee must decide whether it is necessary to verify the contents of licensor deposits into the escrow account. One method of verification involves witnessing the compilation of the deposited source code into usable object code. Compilation may be demonstrated by the licensor or by any of the companies in the source code escrow business. Sometimes the quality of the code is inspected before it is deposited for the purpose of assessing the source code risk. If the source code is not intelligible, added precautions may be considered. One strategy is to require the filing of a video tutorial with the source code that explains the code in detail. Another strategy is for the licensee to have the right to hire key licensor programmers irrespective of any prohibition against soliciting the employees of either party in the event of a triggering condition granting access to source code. These strategies are discussed more fully below.

Deposit Updates The parties should agree on the frequency with which the deposit must be updated. Although customers will want to have the latest version of source code in the event of a licensor default, state-of-the art software often has not matured and releases occur frequently. Licensors of such software may resist an obligation to deposit each new release, and a compromise requiring not more than a specified number of deposits per year might be reasonable. The objective should be to ensure that the source code deposit corresponds substantially with the licensed software then being used by the licensee.

Code Release Triggering Events The parties must specify the events that will permit the customer to receive the source code from the escrow agent. These normally include a licensor's failure to perform a software support obligation and a cessation of the licensor's business, but may also include other events that endanger the licensor's ability to perform its obligations even though there has as yet been no default.

Code Release Procedures The parties must specify the procedure by which the licensee can obtain the source code from the escrow agent. Typical procedures require written notice by the licensee to the escrow agent describing the event that has entitled the licensee to receive the source code. The escrow agent in turn gives the licensor written notice of the licensee's claim. If the licensor does not dispute the licensee's claim, the source code is released. Alternatively, a procedure must be agreed upon to resolve a licensor dispute of the licensee's claim, and arbitration on an expedited basis is a common means.

Supplementary Agreement Under Public Law 100-56, the separate source code escrow agreement is referred to as being "supplementary" to the contract between the licensor and licensee. It is a good idea to make sure that both parties recognize that the source code escrow agreement is acknowledged by both parties to be a supplementary agreement within the meaning of §365(n) of the Bankruptcy Code to make clear that the benefits of §365(n) are intended by the parties to apply. We prefer three-party source code escrow agreements so that the licensee and the licensor are in privity with the escrow agent. In a threeparty contract, the licensee can have the right to pay any escrow fees that the licensor has failed to pay and deduct any such payment from any other payment obligation that the licensee has to the licensor. This payment right recognizes that the most common reason for escrow arrangements to fall apart is non-payment of escrow fees. In the absence of a three-party agreement, the software escrow agreement may be incorporated in the license agreement with contract provisions requiring that the source code deposit be kept current and escrow agreement remain in effect during the term of the license.

Source Code Risk It should be emphasized that source code escrow arrangements carry some definite risks. For complex systems, even with source code access, there are definite concerns that software maintenance may prove to be commercially impractical because the coding may be too difficult to comprehend in a reasonable amount of time. Assessing the source code risk may require a review of the code along with other considerations.

If the program code is not understandable and well documented, you may consider other strategies to improve the likelihood that you will be able to maintain the code. One strategy is to require that the licensor prepare a tutorial video where the programmers would walk the licensee through the code so that the program code is understandable.[13] Likewise, in addition to the source code, technical documentation that will aid in understanding the program code should be stored. During contract negotiations you should seek to make sure that everything that the licensee will need to assume software maintenance and support is stored in escrow or otherwise provided.

Waiver of Prohibition Against Hiring There are a number of contract provisions that should be considered in connection with software source code escrow strategies. Typically, the license agreement is likely to contain a prohibition against hiring licensor employees. Licensor's programmers are likely to be the most knowledgeable personnel concerning the program code. During negotiations, the licensee should seek to identify the most knowledgeable programmers and expressly waive any prohibitions against hiring them in the event the licensee is granted access to the source code.

Waiver of Prohibition Against Reverse Engineering Another contract provision to consider is the prohibition against decompilation, disassembly, translation, or other reverse engineering. This type of prohibition against reverse engineering is included in most software licenses. It does not make any sense if the licensee obtains access to source code. Accordingly, we recommend that the prohibition be waived and the licensee be granted an express right to decompile, disassemble, translate, and otherwise reverse engineer the licensed software in the event that the licensee is granted access to source code. This may provide the licensee with added rights that may prove helpful. For example, if the source code provided is not current, this right may provide the licensee with the rights necessary to reverse engineer or otherwise derive the source code for changes not included in the delivered source code. By matching the software based on the delivered source code with the software the licensee is actually using, the licensee should be able to generate a listing of changes. This listing may be used to obtain current source code from the licensor or as a basis for reverse engineering the changes.

Section 117 Rights Another provision to consider relates to §117 of the Copyright Act, which gives the owner of a copy of the copyrighted software the right to modify the software to the extent necessary to use the software and the right to copy the software for archival purposes. Most court rulings have held that licensees do not have the rights conferred under §117 because they are not owners of the copy of the software licensed to them. To the extent that the licensee obtains source code, we believe that the licensee should be granted all of the rights under §117 with respect to the software and related source code licensed to the licensee. These rights will further strengthen the licensee's rights to modify and adapt the software in the event the licensee must take over maintenance and support of the licensed software.

Perfecting Security Interests and Assignments in Bankruptcy Proceedings

Perfecting a Security Interest in Copyrighted Material *In re Peregrine Entertainment, Ltd. v. Capitol Federal Savings and Loan Ass'n*[14] addresses the issue of whether a security interest in a copyright is perfected by an appropriate filing with the US Copyright Office or by a UCC-1 financing statement filed pursuant to state law.

Capitol Federal Savings and Loan Association had filed UCC-1 financing statements in California, Colorado, and Utah in connection with its extending a line of credit to Peregrine. Capitol's UCC-1 statements and security agreement described the collateral as "[a]ll inventory consisting of films and all accounts, contract rights, chattel paper, general intangibles, instruments, equipment, and documents related to such inventory, now owned or hereafter acquired by the Debtor." No security interest had been filed in the US Copyright Office.

The court noted that the comprehensive scope of the federal Copyright Act's recording provisions, along with the unique federal interests that they implicate, supports the view "that federal law preempts state methods of perfecting security interests in copyrights and related accounts receivable." To the extent that Peregrine had valid copyrights, the Bankruptcy Court was ordered to permit Peregrine to exercise its avoidance powers under the Bankruptcy Code over interests in which Peregrine had not filed its security interest with the US Copyright Office. It should be noted that this ruling relates to perfecting a security interest in registered copyrights. To the extent that a security interest is taken, for example, in trade secrets, unregistered copyrights, and other intangibles, those security interests need to be perfected pursuant to state law by filing a UCC-1 financing statement.

In re World Auxiliary Power Company[15] addresses the perfection of security interests in the debtor's unregistered copyrights. The Ninth Circuit affirmed the district court's ruling that Silicon Valley Bank had a perfected security interest in the debtor's unregistered copyrights. Here, the security agreement and financing statement also covered "[a]ll copyright rights, copyright applications, copyright registrations, and like protections in each work of authorship and derivative work thereof, whether published or unpublished, now owned or hereafter acquired."

The Ninth Circuit adopted *Peregrine* and held that for registered copyrights the only proper place to file a security interest is in the Copyright Office, but noted that there is no way for a secured creditor to perfect a security interest in unregistered copyrights by recording in the Copyright Office. Only the UCC state filing system creates a filing system applicable to unregistered copyrights. As part of its rationale, the Ninth Circuit noted that the Copyright Act contemplates that most copyrights will not be registered. Since a copyright is created every time people set pen to paper or fingers to keyboard and affix their thoughts in a tangible medium, writers, artists, computer programmers, and Web designers would have their hands tied down to keep them from creating unregistered copyrights all day every day. The Copyright Act is noted by the Ninth Circuit to set up a regime in which most copyrights will not ever be registered.

The lesson learned is that a secured creditor may perfect a security interest in an unregistered copyright in accordance with state law by filing a UCC-1 financing statement pursuant to state law. To the extent that the UCC-1 seeks to cover intangible intellectual property rights (*e.g.*, trade secrets, confidential information, domain names, etc.), we recommend that unregistered copyright rights be expressly included in the description of the covered collateral.

Scope of Perfected Security Interest in Registered Copyrights The bankruptcy court in *In re Avalon Software, Inc.*,[16] determined that the Imperial Bank failed to perfect its security interest in Avalon's copyrighted software and did not have a perfected security in any of Avalon's software, modified software, licenses, manuals, or agreements relating to the distribution of the software and proceeds therefrom.

Avalon had borrowed money from Imperial Bank. The bank had filed UCC-1 financing statements with the Arizona secretary of state but never filed a financing statement, its security agreement, or any other document evidencing its security interest with the US Copyright Office. Filing with the Copyright Office and use of an after-acquired clause would have meant that the bank had perfected its security interest in the copyrights and copyrighted material and the proceeds therefrom. As a result, the court determined that a long list of assets was not subject to the bank's security interest, including VAR Distributor Agreements and the proceeds therefrom. On the other hand, the court determined that Avalon's maintenance, consulting, and servicing agreements did not significantly include the sale or licensing of any tangible "intellectual property" and, as such, were subject to the bank's perfected security interest.

Third-Party Software Modifications Not Covered By Security Interest *In re: CTek Software, Inc.*,[17] deals with a number of very important issues related to security interests and bankruptcy. The New York State Business Venture Partnership perfected a security interest in CTek's computer software known as ClienTrak. The security interest covered "the source code and all ownership rights to the computer software ClienTrak including copyrights 1983, 1984, 1985, 1986 and 1987." Later, after granting the security interest, CTek entered into a worldwide right to sell and develop the ClienTrak software. In consideration of the distribution license, the distributor agreed to pay CTek royalties that would decrease in amount over time as the distributor made changes to the software. In particular, CTek gave the distributor the right "to produce, copy, distribute and market derivative versions of the software and documentation without limitation." The distributors' modified version of the software was not subject to the security interest held by the New York State Business Venture Partnership. In the software industry, a distribution agreement like this one effectively transfers the technology from the licensor to the distributor licensee. The New York Business Venture Partnership made a big mistake by not ensuring that its security lien was applicable to the improved software.

The issue before the Bankruptcy Court concerned the extent of the security interest that the New York State Business Venture Partnership had in the source code in light of the modifications made by the distributor after the Partnership's security interest had been perfected. The dispute focused on the changes made to the ClienTrak software after version 3.7.2.B. The bankruptcy court relied on *Stewart v. Abend*,[18] declaring that "the aspects of a derivative work added by the derivative author are the author's property, but the element drawn from the pre-existing work remains on grant from the owner of the pre-existing work."

The bankruptcy court also observed that "[w]orks substantially derived from prior works, whether pre-existing works are copyrighted or in the public domain, are also subject to copyright protection so long as the derivative work itself is original." The bankruptcy court believed that bug fixes had sufficient originality to be independently created copyrightable subject matter, that is, that they were not "trivial" in a copyright sense. The court determined that the software modifications made by the distributor's programmers required independent effort and judgment. In fact, the bankruptcy court, relying on expert proof, noted that "it is more difficult to modify another programmer's source code than to create one's own." Since versions 3.7.2.B of the ClienTrak software, which was subject to the liens of the New York State Business Venture Partnership, could be severed from the current derivative work version of the ClienTrak software, the court ruled that the security interest did not cover the software modifications made by the distributor.

Therefore, by virtue of being able to sever the modifications from the current version (presumably by simply referring to an archival copy of the original software), the distributor was able to overcome the doctrine of accession. The bankruptcy court further ruled that the distributor had a license from CTek to copyright derivative software, the software modifications met the originality requirements of the copyright laws, and the distributor owned those software changes free and clear of any lien from the New York Business Venture Partnership.

As a result, the security interest held by the New York Business Venture Partnership was greatly devalued because it did not apply to the enhanced software. It only applied to the older version, which had become technologically obsolescent.

Perfection of Security Interests in Issued Patents In *Moldo v. Matsco, Inc. (In re: Cybernetic Servs, Inc.)*,[19] the Ninth Circuit affirmed the Bankruptcy Appellate Panel decision that neither the Patent Act nor Article 9 of the Uniform Commercial Code requires the holder of a security interest in a patent to perfect that security interest with the federal Patent and Trademark Office (PTO). Here, the security interest had been perfected pursuant to Article 9 prior to the filing of the bankruptcy petition by filing with the Secretary of State of the State of California.

Section 261 of the Patent Act provides that "[a]n assignment, grant or conveyance shall be void as against any subsequent purchaser or mortgagee for a valuable consideration, without notice, unless it is recorded in the Patent and Trademark Office within three months from its date or prior to the date of such subsequent purchase or mortgage." The Patent Act does not reference a requirement to file a security interest. Only transfers of ownership interests need to be recorded with the PTO. A security interest in a patent does not involve a transfer of the rights of ownership and is not an assignment, grant, or conveyance. The Ninth Circuit referenced the procedures to perfect a security interest in copyrighted materials with the Copyright Office but did not suggest that such procedure was wrong or not necessary, but noted that the Copyright Act governs security interests. The Ninth Circuit suggested that security interests relating to copyrighted materials need to be perfected by filing with the Copyright Office, while security interests in a recorded patent do not have to be filed with the PTO but rather in accordance with Article 9. Accordingly, the security interest in the debtor's patent, timely filed under Article 9 before the filing of bankruptcy, had priority over the trustee's claims.

Assignment of Intellectual Property Assets in Bankruptcy

Section 365(c) of the Bankruptcy Code establishes two conditions that must be met before a debtor-in-possession is prohibited from assigning a license to which the debtor was a party before filing for bankruptcy protection. First, under applicable law the licensor non-debtor must be permitted to refuse performance of the license from another party. Most software licenses, for example, are not assignable unless the licensor has consented to the assignment. Second, the non-debtor licensor has not already consented to (or does not consent to) an assignment.

Patent Licenses Under federal law; non-exclusive patent license agreements are personal to the licensor and are not assignable unless expressly made so in the agreement.

In *Everex Sys. v. Cadtrak Corp. (In re: CFLC, Inc.)*,[20] the Ninth Circuit ruled that the non-exclusive patent license held by the bankruptcy estate was not assignable as part of the assets sold by the debtor in bankruptcy. CFLC had been granted a non-exclusive license to use certain computer graphics technology for which Cadtrak held a patent. In the bankruptcy proceeding, CFLC sought to assume the license and assign it. Cadtrak opposed the assumption and assignment. Under federal law, a non-exclusive patent license is personal and non-assignable. The license could not be assumed and assigned without Cadtrak's consent. The free assignability of a nonexclusive patent license without the consent of the patent holder was deemed to be inconsistent with the patent monopoly and to be inconsistent with federal policy.

The situation respecting the assignability of exclusive patent licenses is less clear. Some courts treat exclusive patent licenses as conferring property rights and not merely personal rights.[21] In such situations, §365(c) should not preclude the assumption or assignment of an exclusive license by the debtor. Other courts have treated the assignability of even exclusive patent licenses as requiring the consent of the patent owner because otherwise an exclusive license would be equivalent of an outright assignment of the patent.

Copyright Licenses Non-exclusive copyright licenses, like non-exclusive patent licenses, are not freely assignable by debtors unless the copyright licensor consents.[22] Like patents, however, it is less clear whether an exclusive copyright license is assignable.[23]

Trademark Licenses Trademark licenses are generally viewed to be personal and non-assignable without the consent of the licensor.[24]

Automatic Stay

One of the main automatic features of a bankruptcy filing is the automatic stay, which is triggered upon filing to preserve the bankruptcy estate until the debtor's property and creditors can be brought together and the competing rights in the bankruptcy estate adjudicated. The automatic stay enjoins the commencement of any action by a creditor against the debtor or the debtor's bankruptcy estate or the continuation of any action by or against the debtor. Furthermore, under the automatic stay any non-debtor licensors or licensees under a license must perform their obligations if non-performance would damage the debtor's bankruptcy estate. The executor contracts remain in effect and creditors are bound to honor them until they are assumed or rejected.

Once a bankruptcy petition is filed, an automatic stay goes into effect. The automatic stay under §362 of the Bankruptcy Code is an injunction against most creditor actions to collect debts from a debtor. The automatic stay is one of the most fundamental debtor protections provided by the bankruptcy laws and may be compromised only when good reason exists to do so.[25]

The automatic stay provisions work to protect the debtor against certain actions by creditors, including: (1) commencing or continuing judicial proceedings against the debtor; (2) actions to obtain the debtor's property; (3) actions to create, perfect or enforce a lien against a debtor's property; and (4) set-off of indebtedness owed to the debtor before commencement of the bankruptcy proceeding.[26]

Secured creditors may petition the bankruptcy court for relief from the automatic stay upon a showing of good cause. The bankruptcy court may give a creditor relief from the stay if the creditor can demonstrate that the stay does not provide adequate protection or if the stay places the creditor's interest in certain property at risk.[27]

Violating the automatic stay may have severe consequences. The Ninth Circuit in *In re: Computer Communications, Inc.*,[28] affirmed a finding that the non-debtor party to a technology development agreement with a termination-upon-bankruptcy clause had violated the automatic stay by unilaterally terminating the agreement. The debtor was awarded compensatory damages and punitive damages.

Invalidity of Termination-upon-Bankruptcy Clauses

Section 365(e)(1) of the Bankruptcy Code provides that an executory contract of the debtor may not be terminated or modified at any time after commencement of the debtor's bankrupt proceeding solely because of a provision in such contract that is conditioned on any of the following:

(1) the insolvency or financial condition of the debtor at any time before the closing of the bankruptcy proceeding;

(2) the commencement of a bankruptcy proceeding;

(3) the appointment of or taking possession by a trustee in a bankruptcy case or a custodian before commencement of a bankruptcy proceeding.[29]

Section 365(e) generally makes clauses that terminate because of the "insolvency" or "financial condition" of the debtor, or due to the filing of a bankruptcy petition, unenforceable once a bankruptcy case has commenced. Section 365(e) generally makes *ipso facto* clauses in executory contracts unenforceable.[30]

Section 365(e) (2) (A) basically provides that termination-upon-bankruptcy provisions are enforceable if (i) applicable nonbankruptcy law does not permit the licensee to assign the license without the licensor's consent and (ii) the licensor has not consented. In this regard, the licensor may give advance consent under the terms of the license.[31]

Most executory contracts contain termination-upon-bankruptcy provisions. It is important not to rely on these termination provisions and to recognize they are likely to be unenforceable. One reason for keeping these clauses in the contract is that the Bankruptcy Code could change to reinstate the old rule enforcing these provisions. Another reason is that the invalidity only arises if a bankruptcy is actually filed.

Conclusion

The risks relating to bankruptcy need to be fully considered in information technology transactions. In this article, a number of risks and strategies under US bankruptcy law were discussed as well as source code escrow strategies to protect licensees and issues relating to perfecting security interests in connection with information technology transactions.

Endnotes

[1] *See* 11 U.S.C. §§101, 365(n) (Supp. 1989). This legislation, in effect, overturned the Fourth Circuit's ruling in Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043 (4th Cir. 1985), *cert. denied*, 475 U.S. 1057 (1986), whereby a debtor licensor had rejected a non-exclusive licensee's license agreement with catastrophic consequences. In the *Lubrizol* case, the bankruptcy court had approved, under the business judgment rule, the rejection of a non-exclusive license for a debtor licensor's patented metal coating process.

[2] In re: TWA, 2001 Bankr. LEXIS 267 (Bankr. Ct. D. Del. Mar. 12, 2001).

[3] Vern Countryman, "Executory Contracts in Bankruptcy: Part I," 51 *Minn. L. Rev.* 439, 460 (1972-1973).

[4] "Intellectual Property" is defined in 11 U.S.C. §101 (35A).

[5] *See* DDB Technologies, LLC v. MLB Advanced Media LP, 2008 US App. LEXIS 11180 (Fed Cir. Apr. 14,2008) (discussing licensing of future interests before the future interest occurs).

[6] In re: EI International, 123 Bankr. 64, 1991 Bankr. LEXIS 18, 18 U.S.P.Q.2d 2045 (Bankr Ct. Idaho 1991).

[7] Encino Business Mgmt. v. Prize Frize, Inc., 32 F.3d 426 (9th Cir. 1994).

[8] Schlumberger Resource Management Services, Inc. v. CellNet Data Systems, Inc., 327 F.3d 242 (3d Cir. 2003).

[9] In re Centura Software Corp., 2002 Bankr. LEXIS 960 (N.D. Cal. Bankr. July 24, 2002).

[10] In re Sunterra Corporation (RCI Technology Corp. v. Sunterra Corp.), 361 F.3d 257 (4th Cir. 2004).

[11] It is noted that this strategy does not run afoul of the rule that a debtor cannot unilaterally contract away its authority to assume or reject an executory contract. *See* In re: TWA, 2001 Bankr. LEXIS 267 (Bankr. Ct. D. Del. Mar. 12, 2001).

[12] *See* In re: Computer Communications, Inc, 824 F.2d 725 (9th Cir. 1987).

[13] In a technology transfer agreement related to a source code license, it is fairly common to include a consulting services component to familiarize the licensee with the source code. The video tutorial may serve that purpose.

[14] In re Peregrine Entertainment, Ltd. v. Capitol Federal Savings and Loan Ass'n., 116 Bankr. 194, 1990 U.S. Dist. LEXIS 10812, 16 U.S.P.Q.2d (BNA) 1017; Copyright L. Rep. (CCH), 26, 616 (C.D. Cal. 1990).

[15] In re World Auxiliary Power Co., 203 F.3d 1120 (9th Cir. Sept. 11,2002).

[16] In re Avalon Software, Inc., 209 Bankr. 517 (D. Az. 1997).

[17] In re: CTek Software, Inc., 127 Bankr. 501; Copy. L. Rep. (CCH) 26,796 (Bankr. Ct. D.N.H. 1991).

[18] Stewart v. Abend, 110 S. Ct. 1750 (1990).

[19] In Moldo v. Matsco, Inc. (In re: Cybernetic Servs, Inc.), 252 F.3d 1039 (9th Cir. Jun. 6,2001).

[20] Everex Sys. v. Cadtrak Corp. (In re: CFLC, Inc.), 89 F.3d 679 (9th Cir. 1996).

[21] Everex Sys. v. Cadtrak Corp. (In re: CFLC, Inc.), 89 F.3d 679 (9th Cir. 1996).

[22] *See* Nike v. Gardner, 279 F.3d 774 (9th Cir. 2002).

[23] *See* In re: Golden Books, 269 B.R. 300 (Bankr. D. Del. 2001).

[24] *See* In re: N.C.P. Marketing Group, 337 B.R. 230 (D. Nev. 2005), *aff'd without op.*, 279 Fed. Appx. 561 (9th Cir. May 23, 2008), *cert. denied*, N.C.P. Marketing Group, Inc. v. BG Star Productions, Inc., 129 S. Ct. 1577, 2008 WL 4522334 (Oct. 6, 2008).

[25] *See* In re Wang Laboratories, Inc., 1996 US Dist. LEXIS 879 (D. Mass. 1996).

[26] *http://en.wikipedia.org/wiki/automaticstay* (last visited October 9, 2009).

[27] *Id*.

[28] In re: Computer Communications, Inc., 824 F.2d 725 (9th Cir. 1987).

[29] "Are 'Termination On Bankruptcy' Contract Clauses Enforceable?" (Posted on September 16, 2007).
http://bankruptcy.cooley.com/2007/09/articles/business_bankruptcy_issues/are_termination_on_bankruptcy_contract_clauses_enforceable?

[30] *Id*.

[31] K. Turner, "The Licensing of Intellectual Property in Bankruptcy," *http://www.ipfrontline.com/depts/article.asp?id=6317dept.d=3&page=2.*