

SOFTWARE LICENSING IN A TROUBLED ENVIRONMENT

REDUCING EXPOSURE TO FINANCIAL LIABILITY

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Reducing Exposure to Financial Liability

By H. Ward Classen and James M. Sullivan

Software is omnipresent in our society. It is so pervasive and intertwined with the operation of most businesses that it would be impossible to successfully operate without it. At the same time, software companies rely on their contracts to protect the sanctity of their ownership interests.

The present economic uncertainties require that both licensors and licensees place greater emphasis on protecting their rights under their existing software licenses and mitigating any potential risks when negotiating a new license. This article examines the risks and liabilities that may arise from the financial instability or bankruptcy of a licensor or a licensee. It discusses several means by which licensors and licensees can reduce their potential exposure to business risk or financial liability.

Software Licenses in Bankruptcy

The treatment to be accorded a software license when the licensor or licensee files for bankruptcy depends

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upon whether the license is executory or nonexecutory. Title 11 of the U.S. Code (Bankruptcy Code) treats executory agreements very differently from nonexecutory agreements. Section 365 of the Bankruptcy Code, which governs the treatment of executory agreements, generally permits a debtor to do one of three things: (1) assume the agreement, (2) assume and assign the agreement to a third party, or (3) reject the agreement. Generally speaking, a debtor may not enjoy the full benefits of an executory agreement unless it assumes all of the obligations under the agreement, including the curing of all prepetition defaults under the agreement. The same is not true with respect to a nonexecutory agreement.

Although the Bankruptcy Code does not define the term *executory*, most bankruptcy courts use the definition formulated by Professor Vern Countryman in *Executory Contracts in Bankruptcy, Part I*, 57 MINN. L. REV. 439 (1973).

... a contract under which the obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.

Thus, where performance has been substantially completed by one or both parties to the contract, the license is nonexecutory.

Whether a bankruptcy court will find a software license to be executory will depend upon a fact-based analysis of the license agreement and the remaining obligations of each party under the license agreement. Although most software licenses with ongoing payment obligations by the licensee will likely qualify as an executory contract, the courts will look to the substance of the license agreement rather than the form in determining whether a contract is executory. Thus, a royalty-free or fully paid-up license of software may not in fact be a license at all, but an assignment of a property interest that is nonexecutory.

The Licensor's Bankruptcy

Nonexecutory License. When a licensor files for bankruptcy, a licensee may be left in a precarious position, especially if its license agreement is non-executory. That is because the licensor may seek to breach the license by refusing to provide necessary support or software upgrades, or, even worse, by relicensing the software to a third party. The Bankruptcy Code offers little protection to a licensee that is a party to a nonexecutory contract with a debtor. In fact, a licensee's sole recourse may be to file a general unsecured claim against the debtor. Accordingly, a licensee should seek to protect itself from a licensor's bankruptcy to the greatest extent possible. Some

techniques include getting a security interest in the licensed software, getting a technology escrow, drafting the license in such a way to ensure that it will be treated as an executory contract entitled to the protections of § 365(n) of the Bankruptcy Code, and/or drafting the license to include equitable remedies that will survive the licensor's bankruptcy.

Executory License. In response to the concern of the software industry and licensees in particular, the federal bankruptcy laws were rewritten in 1987 to protect licensees in the event of a licensor's bankruptcy. Section 365(n) of the Bankruptcy Code provides that in the event the debtor/licensor rejects the license agreement, the nondebtor/licensee has two options. First, it can bring a claim for damages to the extent the rejection caused the licensor to fail to meet the licensor's obligations under the license agreement. Under this option, the licensee forgoes any right to use the licensed technology/software in the future. Second, it can retain the rights to use the software/intellectual property for the period provided for under the license and any contractual extension periods.

The debtor can still reject the license agreement causing any executory provisions to become null and void, but the licensee can elect to retain its rights under the software license. If the licensee elects to retain its intellectual property rights, it must continue to pay the license fees due the licensor and must forgo certain remedies otherwise available under the Bankruptcy Code (e.g., rights of setoff or to assert a § 503(b) administrative priority claim). Under § 365(n), the licensee does not need to affirmatively elect to retain its intellectual property rights to preserve its license.

Most licensees elect the second option, i.e., to continue using the software. Although the licensee may continue using the software, it cannot compel the licensor to perform other contractual obligations except for any exclusivity provisions in the contract. The licensor is relieved of its obligations to provide any ancillary services, such as training, maintenance, support, documentation, or updates. The licensee is able to require the debtor to provide it with any intellectual property in its possession, provided such rights were included in the license.

The licensee must continue, however, to pay all royalties due the licensor. This is a good reason to have separate agreements or payment schedules for the software license and any ancillary obligations, such as development as well as maintenance and support services. Utilizing a single contractual document, rather than multiple documents, will make the agreement appear executory in nature because of the existence of long-term ongoing obligations. Separate agreements or payment schedules lessen the risk of an agreement being rejected because each obligation is compartmentalized and associated with a specific payment and a licensor will not be entitled to receive the separate fee unless it performs the separate service.

Drafting Techniques. To ensure the protections of § 365(n) are available to the licensee, the licensee should make sure the license specifically provides that the licensed software is "intellectual property" under § 101(56) and that the license is governed by § 365(n) in the event the licensor files for bankruptcy protection. [See Sidebar for model language.] Under the Bankruptcy Code, 11 USC § 101(56), "intellectual property" is defined as "(A) trade secrets; (B) invention, process, design or plant protected under title 35; (C) patent application; (D) plant variety; (E) work of authorship protected under title 17; or (F) mask work protected under chapter 9 of title 17; to the extent protected by applicable non-bankruptcy law." It is clear that software will fall under this definition. As such, software will usually be governed by § 365 of the Bankruptcy Code.

In addition, to further ensure that § 365(n) is available to the licensee, the licensee should be sure to include sufficient continuing obligations in the license by both sides to ensure that the license will be deemed an executory agreement. A licensee also should clearly state the contractual obligations that are deemed material, such that the breach by one party of such provision would excuse continued performance by the other party. Doing so will assist a bankruptcy court in applying the

Model Language for the Protection of Licensed Software Under § 365(n) in the Event of Bankruptcy

Set forth below is model language that a licensee should include in its license agreement to ensure that it may avail itself of the protections set forth in § 365(n).

Affirmation of rights. All rights and licenses granted pursuant to any section of this Agreement are, and will otherwise be, for purposes of Section 365(n) of the U.S. Bankruptcy Code and/or any similar or comparable section of the U.S. Bankruptcy Code (as such sections may be modified, amended, replaced, or renumbered from time to time), executory licenses of rights to "intellectual property," as defined under **Section 101 (35A)** of the U.S. Bankruptcy Code and/or any similar or comparable section of the U.S. Bankruptcy Code (as such sections may be modified, amended, replaced, or renumbered from time to time). The parties will retain and may fully exercise all of their respective rights and elections under the U.S. Bankruptcy Code. Accordingly, the licensee of such rights shall retain and may fully exercise all of its rights and elections under the U.S. Bankruptcy Code. Upon the commencement of bankruptcy proceedings by or against either Party under the U.S. Bankruptcy Code, the other Party shall be entitled to retain all of its license rights and use rights granted under this Agreement.

Countryman standard for determining whether an agreement is executory or the point at which an executory agreement becomes nonexecutory.

To limit its financial risk, the licensee should delineate the payments made for collateral obligations, such as training and support, from general royalty/license fees. The licensee should seek to have such collateral obligations contained in a separate agreement or payment schedule. By lumping all fees together, the licensee could be obligated to pay for collateral services that the licensor is no longer providing.

Many licensees seek to further limit their risk in the event of a licensor bankruptcy through the use of a source code escrow. Such an escrow will ensure that the licensee will have access to the source code for the licensed software if the licensor rejects the license and refuses to perform its obligations under the license agreement. [See Sidebar for model language.]

Another option is for the licensee to obtain a security interest in the licensor's software. In addition to protecting the licensee's interest in the software, the security interest also will secure any rejection damages claim available to the licensee in the event the debtor rejects the license agreement. Because the security interest will limit the benefits available to a debtor upon rejecting the license, it will incentivize the debtor to assume the license agreement. In order to perfect a security interest in a licensor's software, the licensee must comply with both the Uniform Commercial Code and copyright law, which requires that a notice be filed with the Copyright Office. The grant of a security interest is considered to be the transfer of copyright ownership.

Finally, the licensee should include equitable remedies in the license agreement, such as the right to enforce any exclusivity provisions in favor of the licensee with an injunction against infringement. Such remedies are particularly important where the license is not executory and thus not entitled to the remedies available under § 365(n). The majority of courts will enforce such a provision where such remedy

is not an alternative or substitute for money damages. Including a provision in the license agreement that a breach cannot be adequately addressed through monetary damages and that equitable relief, such as an injunction, is needed to protect the licensee's rights in the software will increase the likelihood that a court will enforce an equitable remedy.

The Licensee's Bankruptcy

Nonexecutory License. A software licensor's primary concern when a licensee files for bankruptcy is payment. If the license is considered to be

nonexecutory, for example, where the licensor has already substantially performed its obligations under the agreement, then the licensor's sole recourse may be to assert a general unsecured claim against the licensee's estate. Accordingly, a licensor should seek to protect itself from a licensee's bankruptcy to the greatest extent possible. One technique is obtaining a security interest in the licensed software and/or other assets, which will incentivize the licensee to honor its commitments under the license agreement. Another technique is to draft the license in such a way to ensure that it will be treated

Model Language to Ensure the Sanctity of an Escrow Agreement in the Event of Bankruptcy

Set forth below is model language that a licensee should include in its escrow agreement to ensure that it may avail itself of the protections set forth in § 365(n).

Supplementary Agreement. This Escrow Agreement is "supplementary" to the License Agreement within the meaning of section 365(n) of the U.S. Bankruptcy Code (11 USC § 365 (n)) and/or any similar or comparable section of the U.S. Bankruptcy Code (as such sections may be modified, amended, replaced, or renumbered from time to time). If this Escrow Agreement and/or the License Agreement are/is rejected by Licensor as a debtor in possession or a trustee or by any other person or entity under the U.S. Bankruptcy Code, then the Licensee may elect to retain its right as provided in section 365(n). The Parties intend that no bankruptcy or bankruptcy proceeding, petition, law or regulation (and no other proceeding, petition, law or regulation of a similar nature in any state or foreign jurisdiction) will impede, delay or prevent the release of Deposit Materials to Licensee in accordance with the provisions of this Agreement, and the Licensor hereby conveys to Escrow Agent such rights (including intellectual property rights) as are necessary to allow Escrow Agent to lawfully make such release and perform this Agreement.

- (i) Any licenses granted under this Agreement or which are provided pursuant to this Agreement are intended to be executory licenses of rights in intellectual property as contemplated by section 365(n) of the U.S. Bankruptcy Code (11 USC § 365(n)), and/or any similar or comparable section of the U.S. Bankruptcy Code (as such sections may be modified, amended, replaced, or renumbered from time to time). In the event that Licensor becomes a debtor under the U.S. Bankruptcy Code, it is the intent of the Parties that Licensee shall have all benefits granted to licensees under the provisions of the U.S. Bankruptcy Code including, without limitation, section 365(n) of the U.S. Bankruptcy Code and/or any similar or comparable section of the U.S. Bankruptcy Code (as such sections may be modified, amended, replaced, or renumbered from time to time).

as an executory contract, which may make it difficult for the licensee to assume or assign the license without the licensor's consent and thus provide the licensor with greater leverage. Although the restrictions on assignment of an executory software license also may apply to the assignment of a nonexecutory software license, a court might treat a nonexecutory license as a sale or assignment of the software rather than a license, in which case the court may not be inclined to apply the exception to assignment provided for under § 365(c) of the Bankruptcy Code.

Executory License—Termination of License. Many licensors include language in their license agreements automatically terminating the license agreement upon a licensee's bankruptcy. Such provisions, sometimes referred to as ipso facto clauses, are not enforceable. Section 365(e)(1) of the Bankruptcy Code provides that an executory contract of the debtor may not be terminated or modified after a bankruptcy filing because of a provision in the license agreement that is conditioned on the insolvency or financial condition of the debtor or the commencement of a bankruptcy filing. Any attempt by the nonbankrupt party to unilaterally terminate a contract

covered by the provisions of the Bankruptcy Code without first seeking relief from the automatic stay may expose such party to significant liability.

To provide a greater level of protection, a licensor can include certain performance requirements in the license agreement that would allow the licensor to terminate the license agreement if the licensee fails to abide by such requirements. These may include requiring the licensee to continue operating, maintain a minimum amount of sales, or expend a minimum amount on marketing or promotion. These rights are separate and distinct from those provisions typically placed in a license agreement allowing the licensor to terminate the license for the licensee's bankruptcy.

In addition, a licensor may terminate a license prior to a licensee's bankruptcy filing provided the termination is effectuated prior to the licensee's bankruptcy filing. The fact that the effective date of any notice of termination does not occur until after the licensee files for bankruptcy should not affect the result so long as the termination is complete and not subject to cure or reversal, either under the terms of the contract or under state law. Where the termination is subject to cure or reversal at the time of the bankruptcy filing, however, the licensee will have an

opportunity to cure the default under § 365 of the Bankruptcy Code and prevent the termination from occurring.

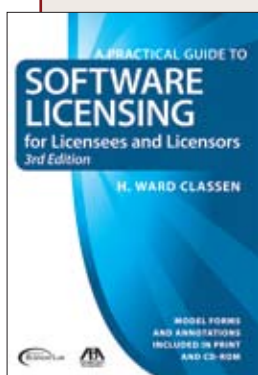
Executory License—Assumption or Assignment of Executory License. Under § 365(b) of the Bankruptcy Code, a software licensee who declares bankruptcy and desires to assume an executory license agreement must cure all breaches, fully perform its obligations under the license agreement, and provide adequate assurances that it will perform in the future. If the licensee fails to do so, it must reject the license agreement and relinquish all rights to the underlying intellectual property.

Furthermore, under § 365(c) there is a limit on a debtor licensee's ability to assign a software license to a third party. For example, it appears that a debtor licensee cannot assign a nonexclusive software license to another entity without the licensor's consent, even where there is no prohibition to such assignment under the license agreement (although there is an exception to assignment of contracts under § 365 where "applicable law" excuses a nondebtor party to an executory contract from accepting its assignment).

The same limitations may not apply to the assignment of an exclusive software license, which may be characterized as an assignment of a property interest rather than the license of limited rights to use the software.

Similarly, at least one court has held that a licensee cannot use a nonexclusive license after its bankruptcy reorganization absent the licensor's consent.

Licensees also need to be concerned about their right to assume a license in the event of their bankruptcy as there is a dichotomy among the federal circuit courts. In *In re Sunterra Corporation*, 361 F.3d 257 (4th Cir. 2004), the Fourth Circuit Court of Appeals held that § 365(c) of the Bankruptcy Code precluded the debtor licensee from assuming the contract without the licensor's consent even though the license agreement permitted the debtor to assign the license. This position, which emphasizes the literal meaning of the statutory language to evaluate the assumption of executory contracts



The third edition of *A Practical Guide to Software Licensing for Licensees and Licensors* by H. Ward Classen examines the fundamental issues that both licensors and licensees confront in the negotiation of a software license and, where appropriate, looks at relevant ancillary issues such as software development as well as maintenance and support. It primarily focuses on non-mass market agreements, since most retail or mass market off-the-shelf software is governed by non-negotiable shrinkwrap and clickwrap licenses. Nonetheless, the principles of software licensing are the same for both shrink-

wrapped, click-wrapped, and custom-developed software. Written in practical, easy-to-understand language, this book is cross-referenced to a model agreement. It is written from the perspective of both the licensor and the licensee and includes model forms with alternative clauses to fit many perspectives. The CD-ROM is a great companion filled with easy-to-use forms.

To order, call the ABA Service Center at **800-285-2221**, or order online at **www.ababooks.org**.

Additional Resources

For more reading on a similar topic, you can retrieve the following article on the *Business Law Today* website at www.abanet.org/buslaw/blt. All issues since 1998 may be accessed under the “Past Issues” heading at the bottom of the web page.

Patent Portfolios in Bankruptcy Cases

Protecting and Maximizing Their Value

By Geoffrey Groshong and Samantha Pak

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(also known as the “hypothetical test”), has been adopted by the Third, Fourth, Ninth, and Eleventh Circuits. The hypothetical test provides that the courts should follow the plain meaning of the statute (§ 365(c)) when the terms of the statute are unambiguous.

The First Circuit along with a majority of bankruptcy courts, however, has adopted the “actual” test, which it believes represents the intent of Congress. Under the “actual test,” a court will examine, on a case-by-case basis,

whether the nondebtor would be required to accept performance from a party other than the party with which it initially contracted. Further, a debtor is not to be prevented from assuming a license unless it actually intends to assign the license to a third party.

Thus, a prudent licensee should include language in its license that in the event of the licensee’s bankruptcy, and subsequent decision to assume the license, the licensor agrees that it will consent to and accept the assumption.

The ramifications of not having such a provision in the license agreement may be so big that it ultimately could affect a licensee’s decision on where to file for bankruptcy protection or whether to file for bankruptcy protection at all. A licensor who agrees to such a provision may wish to limit a consent to assumption provision to situations that do not involve a change in control of the licensee.

Conclusion

Licensors and licensees should both carefully consider the respective bankruptcy protections contained in the applicable license agreement. Waiting until the other party experiences financial instability courts disaster. Each party must understand its rights and act proactively to avoid a potential interruption in its business or the degradation of its intellectual property rights by proactively managing the relationship. By doing so, a party can significantly limit any issues caused by the other party’s bankruptcy.

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