Bankruptcy and the Software License

By Alan S. Wernick

Most companies have software they license for business critical applications. What happens to the business (licensee) if the licensor of the computer software enters bankruptcy? Does the business have to stop using the software altogether or have some restrictions applied to their use? Would the business suffer if it had to stop using any business critical computer programs they currently use? And, if the business fails to immediately stop using the software, will the bankruptcy trustee for the debtor/licensor pursue the business for infringement damages?

Both in good times and challenging economic times, bankruptcy is sometimes the "exit strategy" for some businesses, including software licensors. And, once the licensor's bankruptcy petition is filed, it will only be a matter of time before the licensees feel the impact of that filing.

The drafter of a software license agreement must look ahead in the transaction and consider where the parties want to be in the event of bankruptcy, and then properly weave those considerations into the fabric of the agreement. In the event of the licensor's bankruptcy, the licensee must act precisely and without hesitation to fully avail itself of the benefits of Sec. 365(n) of the Bankruptcy Code.

Under Sec. 365(n) of the U.S. Bankruptcy law (11 U.S.C. Sec. 365(n)(1)), a licensee has the option of (a) terminating the license agreement, if rejection by the trustee amounts to such a breach as would entitle the licensee to treat such contract as terminated by its own terms, applicable non-bankruptcy law, or an agreement made by the licensee with another entity, or (b) retaining the licensee's rights (including the right to enforce any exclusivity provision of such license agreement, but excluding any other right under applicable non-bankruptcy law to specific performance of such contract) to the computer software, subject to the limitations set

forth in Sec. 365(n). The license agreement should address the rights the licensee will have in the event of the licensor's bankruptcy. However, when the license agreement is silent on the issue of the licensor's bankruptcy, there may be other provisions of the agreement or other documents that will impact the analysis and the outcome as to whether or not the licensee may continue to use the software in some manner or another for the licensee's business. One such other document is the source code escrow agreement which when properly drafted (and the escrow properly maintained) may, in the event of the licensor's bankruptcy, provide both legal and practical remedies to the licensee.

When an owner of certain types of intellectual property comes under the protection of the Bankruptcy Court, the rights of licensees are at risk with regard to that intellectual property (including trade secret, invention, process, design, or plant protected under U.S.C. Title 35; patent application; plant variety; work of authorship protected under U.S.C. Title 17 -- such as computer programs; or mask works protected under U.S.C. Title 17; to the extent protected by applicable non-bankruptcy law). In the past, that risk might clearly have been that the licensee would lose its license rights to the licensed technology, as was the case in *Lubrizol Enterprises Inc. v. Richmond Metal Finishers, Inc.*, (4th Cir. 1985).

However, Congress addressed the *Lubrizol* problem by enacting the "Intellectual Property Bankruptcy Protection Act of 1987 -- An Act to Keep Secure the Rights of Intellectual Property Licensors and Licensees Which Come Under the Protection of Title 11 of the United States Code, The Bankruptcy Code." But, as seen in *In Re El International* (U.S. Bankruptcy Court for the District of Idaho, 1991), a licensee of computer software failed to retain its rights to licensed software when its licensor went into bankruptcy. Thus, even though Sec. 365(n) exists in the bankruptcy statutes, the licensee may still lose, or have limitations placed upon, its licensed rights to the technology.

Appropriate language for addressing the bankruptcy issue in a software license agreement will depend upon the particular facts of the transaction. Depending on those facts, one drafting tip may be for the software license agreement to provide that "…failure by the

Licensee to assert its rights to 'retain its benefits' [to the intellectual property encompassed by the software], pursuant to Sec. 365(n)(1)(B) of the Code, 11 U.S.C., under an executory contract rejected by the trustee in bankruptcy, shall not be construed by the courts as a termination of the contract by Licensee under Sec. 365(n)(1)(A) of the Bankruptcy Code."

If, on the other hand, the licensee enters into bankruptcy, the question arises as to whether or not the trustee for the debtor/licensee can assign the software license as an asset of the debtor. This analysis will depend on several things including whether or not the license is an exclusive or nonexclusive license, and how the issue of assignment is addressed in the license agreement. The few cases that have examined the issue of assignment and assumption of a software license agreement in the bankruptcy context have turned to the copyright law analysis of the issue, a discussion of which is beyond the scope of this article.

The bottom line of the licensee's failure to take appropriate action in the event of the licensor's bankruptcy may result in the licensee's loss of its rights to the licensed technology. The licensee must not procrastinate when faced with rejection of an executory contract. Under Sec. 356(n) of the Bankruptcy Code, it must proceed promptly to assert its rights under this provision to retain its rights to the software covered under the agreement, or alternatively, pursue its monetary claims provided for in the contract.

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