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Protecting Against Bankruptcy of an ASP

By Carefully Negotiating Contract Terms, Customers Can Reap Advantage of Code's §365(n)

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Customers of an application service provider (ASP) can be at great risk when the ASP enters bankruptcy. That is because ASPs (and their bankruptcy trustees) typically have the ability to reject technology license agreements as executory contracts, jeopardizing a licensee's use of a licensed technology or process that may be crucial for its business.¹ Fortunately, Bankruptcy Code §365(n) provides substantial protection to licensees who carefully negotiate the terms of ASP contracts in advance.²

At its simplest, §365(n) allows a licensee to continue to enjoy certain benefits of a license agreement for intellectual property for the term of the license, and any extension periods, under certain conditions regardless of whether the intellectual property license is rejected in bankruptcy. Indeed, §365(n) protects not only a licensee's use of the intellectual property that is the subject of the agreement but any right to exclusivity the licensee enjoyed at the time the licensor filed for bankruptcy.

Because an ASP's rejection of a license terminates its obligations under the license, including its obligations to support and maintain the application program, a licensee even with the benefit of §365(n) incurs some loss of contract benefits. Nonetheless, a licensee may wish to continue using an application program at least on an interim basis for a variety of reasons, such as avoiding the cost of implementing new software or allowing it appropriate transition time to move to a new vendor.

Eligibility for the Section

Section 365(n) deals exclusively with licenses for intellectual property that the Bankruptcy Code defines as copyright, patent and trade secrets.³ Importantly, the section does not extend to trademark licenses. In addition, if an ASP

agreement is structured mainly as a service agreement and the license to access and use the application is plainly secondary, a court very well may consider the license to be de minimis to the overall agreement and characterize the ASP agreement as something other than an intellectual property license. Under those circumstances, a licensor in bankruptcy or its trustee could reject the ASP agreement and the licensee would have no protection under §365(n).⁴

Thus, a licensee must take care to ensure that its ASP agreement characterizes itself as an intellectual property license subject to §365(n). Moreover, a licensee entering into an ASP agreement may want to separate the service agreement from the license agreement to try to insure protection of the license agreement under §365(n). At a minimum, an ASP agreement should contain a clear grant of a license to use intellectual property and a statement of the parties' intention to enter into an intellectual property license.

Licensee's Obligations

A licensee that decides to retain its rights to intellectual property after a license has been rejected by the licensor must continue to perform its obligations under the license. In particular, a licensee must:

- continue to pay all "royalties" due throughout the term of the license, including any extension of the license term,
- waive the right to offset royalties it owes the licensor against damages arising from the licensor's rejection of the license, and
- relinquish any claim for administrative expenses in connection with the license.⁵

The statute requires that a licensee pay all royalty amounts to maintain the licensed rights. However, ASP

agreements often collapse use fees with support and maintenance fees under one title, making no distinction between one type of fee or the other. That can cause problems for a licensee following a rejection of an ASP agreement, because support and maintenance fees generally are not considered royalties, as they are associated with specific services that an ASP is no longer required to perform after rejecting a license.

A licensee will be in a better position to avoid paying those amounts if its agreement separates the payment to the ASP into its constituent parts—that is, license fee, hosting fee, support fees, maintenance fees, help desk fees, and the like—and provides a sufficient description of what each fee entails. In this way, a court can distinguish between fees for the use of the intellectual property, which the licensee must continue to pay, and fees for services that the licensee no longer receives post-bankruptcy and that it therefore may be relieved of paying.⁶

Obtaining Services

Prior to an ASP's decision to accept or reject a license in bankruptcy, it must, at the licensee's request, perform its obligations under the license or deliver to the licensee any intellectual property it holds, including "any embodiment of such intellectual property" (which for an ASP is typically the software in object code and source code), to the extent provided in the license agreement or any supplementary agreement.⁷ It must also refrain from interfering with the licensee's rights to the intellectual property as provided in the license, including any right to obtain the embodiment of the intellectual property from a third party. The ASP agreement or a supplementary agreement such as an escrow agreement should provide for this contingency.

Once an ASP license is rejected in bankruptcy, an ASP operating as a debtor-in-possession, or its bankruptcy trustee, is relieved from all future performance, including any obligation to host the application or provide upgrades, enhancements, patches, support or maintenance. Depending on the type of intellectual property product at issue, the loss of such benefits may prove very substantial to a licensee indeed. This may be especially true for companies that outsource mission-critical technology as they downsize their information technology departments in an effort to concentrate on "core" businesses.

Because the real value in an ASP agreement often lies in the services provided by the licensor that do not survive rejection under §365, such as hosting the application and

providing security and backup services, a licensee may decide to rely on §365(n) only if it can support the application program itself. That can happen if the licensee is prepared to step back into the role of IT provider after its ASP enters bankruptcy.

Under §365(n), an ASP's obligation to deliver intellectual property is limited, both before and after rejection, to what the agreement provides. Having sufficient provisions in a license or a supplementary agreement such as an escrow agreement for the release of software and source code therefore is critical. In each case, the ASP license or escrow agreement should provide for the release of the software and source code as the "embodiment" of such intellectual property.

Licensors generally treat source code as trade secrets and rarely are eager to release source code or include use of the source code in a license grant. Nonetheless, an ASP agreement should provide for the release of the software and source code under limited circumstances, such as rejection of the license in bankruptcy, failure to maintain or support the software or repeated failures in hosting the application.

Entering into a third-party escrow agreement may facilitate release of the software and source code when the time comes. Sometimes, however, these agreements are not well conceived. Licensees may underestimate the difficulty of maintaining software even with possession of source code. The deposit of software and source code alone may not be sufficient; additional explanatory information, programs and hardware may be necessary to fully deploy an application program.

License agreements and escrow agreements also tend to skimp on provisions to maintain current versions of software and source code in escrow. Licensees stand to benefit from stronger provisions requiring periodic updates of escrow material. License agreements or escrow agreements also should spell out the licensee's rights in the event the software and source code is released to the licensee. At a minimum, the licensee must be granted the right to use the software, modify the source code and create derivative works, either itself or through a third party, to maintain and enhance the software going forward.

In addition, a licensee under an ASP agreement should consider the impact of "downtime" on its business in the event a licensor fails to host and support the application program. In circumstances where even a one- or two-day outage would be harmful to a licensee's business, release of the software and source code may occur too late to be of any

use. Thus, a licensee may want to maintain a “mirrored” site under its control, that is, a site that is identical to the site maintained by the ASP. The ASP agreement thus should grant the licensee a license to use and maintain the “mirrored” site that is triggered upon the licensor’s failure to provide certain services. Section 365(n) will apply to such a license, even though the license to use the mirrored site may not have commenced at the time of the bankruptcy filing.

Licensors recognize the value of keeping source code confidential, including after their bankruptcy. Often times, the value of software, and hence a licensor’s ability to realize value from its sale, is directly and inversely related to the release of the source code for that software. If the release of source code from escrow results in copies of the source code in the hands of many customers, controlling the spread of the copies becomes difficult, if not impossible. Licensees therefore should expect that licensors will seek to include specific, detailed confidentiality provisions in license and escrow agreements that attach to the released source code.

Licensees also are likely to find that their use of source code will be limited to that necessary to provide the level of maintenance and support contemplated by the ASP agreement. Licensees usually will not be entitled to greater benefits upon release of the software and source code than they otherwise would have had if the licensor had continued to provide support and maintenance under the ASP agreement.

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Conclusion

As more and more companies turn to outsourcing for essential business applications, protecting access to and use of the application while minimizing downtime following an ASP’s bankruptcy filing can be essential. Bankruptcy Code §365(n) can help licensees if they plan for the possible bankruptcy of their ASP while negotiating the terms of the ASP license.

Notes

¹ See, e.g., *In re Access Beyond Technologies, Inc., n/k/a Hayes Corporation (Hong Kong) Limited, et al.*, 237 B.R. 32 (Bankr. D. Del. 1999).

² 11 U.S.C. §365(n).

³ 11 U.S.C. §101(35A).

⁴ See Richard M. Cieri and Michelle M. Morgan, “Licensing Intellectual Property and Technology from the Financially-Troubled or Startup Company: Prebankruptcy Strategies to Minimize the Risk in a Licensee’s Intellectual Property and Technology Investment,” *The Business Lawyer*, Vol. 55 August 2000, p.1649, 1685.

⁵ 11 U.S.C. §365(n)(2).

⁶ See, e.g., *Prize Frize, Inc. v. Encino Business Management, Inc.*, 32 F.3d 426, 429 (9th Cir. 1994) (“payments by licensee to licensor for the use of intellectual property are, indifferently, ‘licensing fees’ or ‘royalties,’ and, as royalties, must be paid by the licensee who elects to keep its license after the licensor’s bankruptcy”).

⁷ 11 U.S.C. §365(n)(4).

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