

## The Software Bankruptcy Trap

*Avoiding licensee loss of rights under Sec. 365(n) of the Code*

© Copyright 1991 ALAN S. WERNICK

*Computer Law Strategist*

Volume 7, Issue 12, April 1991

*By Leader Publications, Affiliated with the New York and National Law Journals*

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 without hesitation and precisely to fully avail itself of the benefits of Sec. 365(n) of the Bankruptcy Code.

The bottom line of the licensee's failure to do either of these 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 the new 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.

In a recent case, a licensee of computer software failed to retain its rights to licensed software when its licensor went into bankruptcy. 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 chapter 9 of U.S.C. Title 17; to the extent protected by applicable non-bankruptcy law). In the not-too-distant 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.*, 756 F.2d 1043 (4<sup>th</sup> Cir. 1985). (*Computer Law Strategist*, September 1985).

However, in 1987, 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 Licensees and Licensees Which Come Under the Protection of Title 11 of the United States Code, The Bankruptcy Code" (*Computer Law Strategist*, November 1988). But, as seen in a recent case, even though this new law, Sec. 365(n) exists in the statutes, the licensee may still lose its licensed rights to the technology.

### **Background**

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.

### ***'El International' Case***

Upon the filing of licensor's bankruptcy, the licensee must act in order to avail itself of the rights afforded by Sec. 365(n) of the U.S. Bankruptcy law. A licensee exercising its rights under Sec. 365(n) must be prepared to adhere to obligations imposed upon the licensee under Sec. 365(n)(2) (a discussion of those obligations is found in "New Act Protects Licensee's, Rights if Licensor Files for Bankruptcy" -- Law covers problems raised by *Lubrizol*, cited above).

The recent case of *In re: El International*, No. 90-00646-11 (U.S. Bankruptcy Court for the District of Idaho, Jan. 7) is an example of a licensee's failure to act in accordance with Sec. 365(n). The result was that the licensee lost its rights to the technology and ended up with a termination of the license agreement.

### ***Ch. 11 Petition Filed***

In *In re: El International*, the reorganized debtor, El International, a software developer, had agreed to provide its PMAX software system to a licensee, Ontario Hydro. Ontario Hydro is a Canadian corporation and public utility, which provides electricity in the Province of Ontario, Canada. After El International's filing a chapter 11 petition, the executory license agreement with Ontario Hydro was rejected by the debtor, El International, under Sec. 365 of the U.S. Bankruptcy Law (11 U.S.C. Sec. 365).

At the time of filing the Chapter 11 petition in Bankruptcy, El International had not completed the software system it had contracted to provide to Ontario Hydro. The system El International had agreed to supply contained mostly customized computer software built to Ontario Hydro's specifications. The parties had conducted their business arrangements through a series of purchase orders. The primary contract between the parties consisted of Ontario Hydro's form purchase orders, which incorporated a document entitled "Contract Standard," the heading of which read "Standard Commercial Conditions for Purchase of Data Processing Equipment." This document referred to yet another document entitled "Discussions of the Commercial Issues," which the court found to be a summary of the

modifications contemplated by the parties to the purchase orders and the Contract Standard document.

### ***General Language***

The agreement between the parties contained general language which authorized Ontario Hydro "... to treat (the) contract as terminated by virtue of its own terms..." Another provision of the agreement, the "Contract Standard," between the parties allowed termination of the agreement in the event of the rejection of the contract by the reorganized debtor. Furthermore, the agreement provided that Ontario Hydro had the right to cancel any uncompleted or unperformed portion of the work or part thereof and, in such event, receive a settlement from El International.

### ***Reimbursement Provision***

According to the agreement, such settlement would include "reimbursement at the contract rate for all completed items; reimbursement for the costs to the Company [El International] for work in progress and expenses incurred in the course of the work, plus a reasonable return on such costs and expenses, and reimbursement for cost and expenses directly caused by the cancellation. Ontario Hydro shall not be liable to the Company for loss of anticipated profit on the cancelled portion or portions of the work. In the event of failure to agree on a settlement, Ontario Hydro shall pay to the Company all agreed amounts and the liability for the balance shall be treated as a claim under the "Rights, Claims and Arbitration Clause."

Thus, the court concluded, Ontario Hydro has the right to treat the contract between the parties as terminated under Sec. 365(n)(1)(A) and, since Ontario Hydro had not opted to "retain its benefits" under the rejected agreement as allowed by Sec. 365(n)(1)(B), the extent of its claim will be determined as if the contract had been rejected under Sec. 365(n)(1)(A).

The bottom line of this analysis is that Ontario Hydro's claim against El International received the same treatment as any other claim resulting from a rejected executory contract under Sec. 365 of the U.S. Bankruptcy Code.

As such, Ontario Hydro was held entitled only to the damages it would have sustained as a pre-petition claim for the breach of the agreement by El International, without regard to damage clauses contained in the agreement between the parties.

***Drafting Tip***

The drafting tip indicated by the *El International* case is that language should be provided by Licensee's counsel in the software agreement 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."

*ALAN S. WERNICK, a partner in the law firm of Quarles & Brady, is a member of the firm's Intellectual Property Group and a member of the bars of the District of Columbia, Illinois, New York, and Ohio. Since 1982, Mr. Wernick's practice has focused on computer law, copyright, trademark, trade secret, and licensing law, with an emphasis on the legal and business needs of the computer and information industries, and e-commerce. He provides practical legal advice and strategic counseling to clients in connection with significant transactional and dispute resolution matters in technology, intellectual property, e-commerce, licensing, computer system acquisitions, and outsourcing. Mr. Wernick serves in leadership roles in several national and international organizations involved with computer law and e-commerce issues. He is a frequent speaker and writer on computer law and intellectual property law issues, and serves on the advisory boards of several publications. Mr. Wernick has a technical background in computer programming. For additional information about Quarles & Brady please visit [WWW.QUARLES.COM](http://WWW.QUARLES.COM) or about Mr. Wernick's practice and his publications, please visit [WWW.WERNICK.COM](http://WWW.WERNICK.COM). Mr. Wernick can be reached at 312.715.5151 or by e-mail at [ALAN@WERNICK.COM](mailto:ALAN@WERNICK.COM)*