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Software Licenses Through the Bankruptcy Looking Glass: Drafting Individually Negotiated Software Licenses that Protect the Client's Interests in Bankruptcy

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INTRODUCTION

Today software license agreements are universal.[1] Almost every functioning modern company licenses software, either as vendor or user, to help run the business. Even after the technology industry downturn, many technology companies base their business model on licensing out their technology.[2] These licenses are typically sophisticated contracts with ongoing obligations for both parties: service, support, and upgrade responsibilities on the part of the licensor, and confidentiality requirements and copyright and use restrictions on the part of the licensee.[3]

In addition to basic contract law that applies to the actual software license, software vendors also rely on trade secrets doctrine and copyright law to protect their products.[4] However, despite updates in intellectual property law to accommodate the challenges software presents,[5] licenses are still the predominant method for transferring software rights from one party to another.[6] One reason for the prevalence of software licenses in the industry is that it permits software companies the control they need in a rapidly changing technical environment, without waiting for the law to catch up.[7] For example, licensing permits the vendor to restrict the licensee's right to use software in ways not allowed in

[1] *See* Viktoria L. Gres, *Rejection of Computer Software Licensing Agreements in Bankruptcy*, 8 CARDOZO L. REV. 361, 366 (1987).

[2] *See* Geoff Nairn, *FT REPORT—DIGITAL BUSINESS: Innovation Highlights Flaws in Licence Model*, FINANCIAL TIMES (London), Mar. 8, 2006; *CDC Corporation Announces Preliminary Financial Results and Certain Operating Metrics for Q4 2005 and Full Year 2005*, PR NEWSWIRE US, Mar. 3, 2006, *available at* http://www.cdccorporation.net/newsroom/news/000493.shtml.

[3] *See* Adobe Systems, Inc. v. One Stop Micros, Inc., 84 F. Supp. 2d 1086, 1091–91 n.2 (N.D. Cal. 2000).

[4] *See, e.g.*, Duncan M. Davidson, *Protecting Computer Software: A Comprehensive Analysis*, 23 JURIMETRICS J. 337, 340 (1983).

[5] For example, the enactment of the Computer Software Copyright Act of 1980 provided that software could be copyrighted. 17 U.S.C. § 117 (2000). In addition, the Patent and Trademark Office refused software patent applications until 1981, when the Supreme Court held that an otherwise patentable invention does not become unpatentable because it uses an algorithm or a computer program. Diamond v. Diehr, 450 U.S. 175, 187 (1981).

[6] *Adobe*, 84 F. Supp. 2d at 1091.

[7] *Id.* at 1092 (Amy Grant's expert testimony).

sales relying only on the provisions of the Copyright Act.[8] When using a license, the vendor can "make multiple 'sales' to the same 'buyer' of a copyrighted product that normally could only be sold once to a buyer."[9] The vendor can also prevent the licensee of a copy of a computer program from disposing of the copy under the first sale doctrine of the Copyright Act.[10] In addition, the license agreement allows the licensee to obtain maintenance, performance guarantees and other service arrangements from the licensor that enhance the value of the software.[11]

In order to give both parties in a software license agreement the control they desire over their future rights and obligations, the license must be drafted to anticipate the bankruptcy of either party.[12] The policy of the federal intellectual property laws to stimulate innovation[13] may clash with the goals of the bankruptcy

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[8] Copyright protects only the expression of a work of authorship, but does not protect the ideas embodied within the work. 17 U.S.C. § 102(b) (2000). Copyright also does not protect decompilation and reengineering of software, which has been found to be a fair use. Sega Enters. v. Accolade, Inc., 977 F.2d 1510, 1518 (9th Cir. 1992).

[9] 2-8 MATTHEW BENDER, COMPUTER CONTRACTS § 8.01 (2006); *see* 17 U.S.C. § 106(3) (2000).

[10] BENDER, *supra* note 9, § 8.05.

[11] Ronald J. Mann, *Secured Credit and Software Financing*, 85 CORNELL L. REV. 134, 140–41 & n.12 (1999) (noting impracticality of implementing licenses without "continuing assistance and maintenance from the software developer"); *see* Raymond T. Nimmer et al., *License Contracts Under Article 2 of the Uniform Commercial Code: A Proposal*, 19 RUTGERS COMPUTER & TECH. L.J. 281, 293 (1993) (stating "value conveyed in a software transaction is often independent of the tangible item involved"). *But see* Michael L. Rustad & Thomas H. Koenig, *The Tort of Negligent Enablement of Cybercrime*, 20 BERKELEY TECH. L.J. 1553, 1560–66 (2005) (arguing that courts have failed to police the licensing system, leaving consumers with substandard software licensed without necessary support).

[12] *See, e.g.*, Gres, *supra* note 1, at 371–72; *see generally* David R. Kuney, *Intellectual Property Law in Bankruptcy Court: The Search for a More Coherent Standard in Dealing with a Debtor's Right to Assume and Assign Technology Licenses*, 9 AM. BANKR. INST. L. REV. 593 (2001) (discussing the tension between conflicting approaches to assignability in intellectual property and bankruptcy law and implications for licensees).

[13] Everex Sys., Inc. v. Cadtrak Corp. (*In re* CFLC Inc.), 89 F.3d 673, 679 (9th Cir. 1996) (quoting Bonito Boats, Inc. v. Thunder Craft Boats, Inc., 489 U.S. 141, 150–51 (1989) (stating the patent system "encourage[s] the creation and disclosure of new, useful, and non-obvious advances in technology and design in return for the exclusive right to practice the invention for a period of years")); David I. Cisar et al., *Exclusive and Non-exclusive IP Licenses and Executory Contract Assumption and Assignment: Does Exclusivity Matter?*, 22 AM. BANKR. INST. J. 28 (Feb. 2003).

code (giving the debtor a meaningful chance to reorganize and make a fresh start and providing the maximum return to creditors).[14] Thus, license provisions written without a thorough understanding of the bankruptcy environment can lead to surprising and sometimes devastating results for both the licensor and the licensee.[15]

This Article examines a number of issues that occur when one of the parties to a software license agreement files for bankruptcy. First, this Article will discuss the status of software license agreements in bankruptcy. Second, this Article will examine the bankruptcy issues that affect licensees, both when the licensor is the debtor and when the licensee itself is the debtor. Third, this Article will examine the bankruptcy issues that affect licensors. Finally, this Article will provide practical guidelines to use when drafting a license agreement in order to minimize the potential problems related to one party's bankruptcy. Although there are many kinds of software license agreements,[16] all of which should be drafted with bankruptcy in mind, this Article will focus on software license agreements that are individually negotiated and drafted, typically between two companies, one of which is a vendor and the other a user of the software.

I. SOFTWARE LICENSE AGREEMENTS IN BANKRUPTCY

A. General Overview of Executory Contracts in Bankruptcy

When a debtor files for bankruptcy, one of the first steps is to find all of the debtor's assets and gather them into the bankruptcy estate for eventual disbursement to creditors.[17] In the case of outstanding contracts, whether they become part of the bankruptcy

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[14] Richard Lieb, *The Interrelationship of Trademark Law and Bankruptcy Law*, 64 AM. BANKR. L.J. 1, 2 (1990).

[15] *See generally* J. Dianne Brinson, *Software Distribution Agreements and Bankruptcy: The Licensor's Perspective*, 64 WASH. L. REV. 499 (1989) (discussing the effects of licensee bankruptcy on licensors and possible contractual prophylactics).

[16] Common examples of license agreements are mass-market end-user license agreements ("EULAs"), distribution, and resale agreements. Gres, *supra* note 1, at 366–74.

[17] DOUGLAS G. BAIRD, ELEMENTS OF BANKRUPTCY 92 (3d ed. 2001).

estate depends on several factors.[18] First, it must be determined if the contract is an asset or a liability to the debtor.[19] This determination is fairly obvious if one of the parties has fully performed and one party has at least some portion of its obligations outstanding.[20] The beneficial contract will be swept into the bankruptcy estate for the benefit of the debtor and the creditors.[21] On the other hand, the debtor will breach a detrimental contract, giving the other party a claim against the bankruptcy estate.[22]

If, however, both parties to the contract have enough outstanding obligations to classify the contract as executory, the contract can be both an asset *and* a liability to the debtor.[23] In this situation, the bankruptcy code authorizes a debtor in possession or bankruptcy trustee to assume, assign or reject the contract.[24] This essentially allows the debtor to sweep any favorable contract into the bankruptcy estate (assumption),[25] sell the debtor's interest in the contract to a third party (assignment)[26] or breach an unfavorable contract giving the other party a claim on the bankruptcy estate (rejection).[27] Of course, this is a simplification of the process and the choices of the debtor will depend on the exact provisions contained within the contract. The goal of this Article is to allow the parties to a software license agreement to anticipate the bankruptcy definition of their contract giving them the ability to control, ex ante, the choices a debtor will have in bankruptcy regarding their agreement.

Because of the choice it allows to debtors, it is important to determine whether the software license is considered an executory contract under § 365 of the Bankruptcy Code. Whether a contract is executory depends on the obligations of the parties set forth in the agreement and the degree to which the parties have performed

18 *See id.* at 109–29.
19 *Id.* at 109–12.
20 *See id.* at 109.
21 11 U.S.C. § 541(a)(1) (2000).
22 BAIRD, *supra* note 17, at 111.
23 *Id*. at 109.
24 11 U.S.C. § 365 (2000).
25 BAIRD, *supra* note 17, at 120–26.
26 *Id.*
27 *Id.* at 112–20.

their duties as of the bankruptcy petition.[28] Courts focus on the economic realities of the transaction as opposed to the labels used in the agreement (such as "license" or "royalty payment").[29]

The Bankruptcy Code does not explicitly define "executory contracts."[30] The most widely accepted definition is based on a formulation put forth by Professor Vern Countryman in the early 1970s defining executory contracts as those in which "the obligations of both the bankrupt and the other party to the contract are so far unperformed that failure of either to complete performance would constitute a material breach excusing the performance of the other."[31] Determining what acts or omissions constitute a material breach requires an analysis of applicable non-bankruptcy law.[32] The classification of executory contracts will be discussed in more detail specifically regarding software license agreements later in this Article in Parts I.D and E.

B. Assumption and Assignment of Executory Contracts

Once it is determined that a contract is indeed executory, § 365 authorizes the debtor in possession or trustee ("DIP/trustee") to assume, assume and assign, or reject that contract.[33] The DIP/trustee must cure certain defaults before assuming the executory contract and must provide adequate assurance of future performance of executory contracts that are in default.[34] All assumptions are subject to the court's approval, but most bankruptcy courts apply a relatively liberal "business judgment"

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[28] *See* Enter. Energy Corp. v. United States ex rel. IRS (*In re* Columbia Gas Sys., Inc.), 50 F.3d 233, 239 (3d Cir. 1995). *See generally* Stuart M. Riback, *Intellectual Property Licenses: The Impact of Bankruptcy*, *in* UNDERSTANDING THE INTELLECTUAL PROPERTY LICENSE 2004, at 215 (PLI 2004).

[29] *See* Microsoft Corp. v. Dak Indus., Inc. (*In re* DAK Indus., Inc.), 66 F.3d 1091, 1095 n.2 (9th Cir. 1995).

[30] BAIRD, *supra* note 17, at 109; BRINSON, *supra* note 15, at 511.

[31] Vern Countryman, *Executory Contracts in Bankruptcy Law: Part I*, 57 MINN. L. REV. 439, 460 (1973). *See also In re* Access Beyond Techs. Inc., 237 B.R. 32, 43 (Bankr. D. Del. 1999), *citing Enter. Energy*, 50 F.3d at 244 n.20.

[32] *Enter. Energy*, 50 F.3d at 238.

[33] 11 U.S.C. § 365(a) (2000).

[34] 11 U.S.C. § 365(b).

standard in assessing any disputes over assumptions.[35] Upon the court's approval of the assumption of an executory contract, the entire contract is reinstated and becomes fully binding.[36] This right to assume may not be waived by a contract provision or other pre-petition agreement, but it may be affected by non-bankruptcy law, as discussed later in Part III.[37]

Once a debtor assumes an executory contract, it may seek to assign that contract to a third party. Bankruptcy law generally authorizes the assignment of executory contracts even though the contract itself (or applicable non-bankruptcy law) may prohibit assignment.[38] This is to afford the bankrupt estate the greatest flexibility in reorganizing its business and obtaining value for its creditors, even where the agreement expressly prohibits assignment.[39] The Code, however, provides several exceptions and limitations on the assignment of contracts.[40] Of greatest significance to software license agreements, the Bankruptcy Code prohibits the assignment of an executory contract where "applicable law excuses a party, other than the debtor, to such contract . . . from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract . . . prohibits or restricts assignment of rights or delegation of duties"[41] and "such party does not consent to such assumption or assignment."[42] This exception encompasses non-exclusive copyright and patent licenses, which are non-assignable.[43] The rationale behind this

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35 *See* Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc. *(In re* Richmond Metal Finishers, Inc.), 756 F.2d 1043, 1047 (4th Cir. 1985) (describing business judgment standard as deferring to debtor's decision to assume or reject unless such decision was "in bad faith or in gross abuse of bankrupt's retained business discretion").

36 *See* Tenet Healthcare Phila., Inc. v. Nat'l Union of Hosp. Employees (*In re* Allegheny Health, Educ. and Res. Found.), 383 F.3d 169 (3d Cir. 2004) (holding that an executory contract must be assumed in its entirety).

37 *See In re* Trans World Airlines, Inc., 261 B.R. 103, 113 (Bankr. D. Del. 2001).

38 11 U.S.C. § 365(f)(1) (2000).

39 *See, e.g.,* FutureSource LLC v. Reuters Ltd., 312 F.3d 281, 286 (7th Cir. 2002); *In re* Wash. Capital Aviation & Leasing, 156 B.R. 167, 175 (Bankr. E.D. Va. 1993).

40 11 U.S.C. § 365(c) (2000) as referenced in § 365(f)(1).

41 11 U.S.C. § 365(c)(1)(A).

42 11 U.S.C. § 365(c)(1)(B).

43 *In re* Golden Books Family Entm't, 269 B.R. 300, 309 (Bankr. Del. 2001) ("Under copyright law, 'a nonexclusive licensee has only a personal and not a property interest in

policy is that licenses are similar to personal services contracts.[44] The licensor has evaluated and relied on the promised performance of the named licensee when negotiating the terms of the license, and any substitution of licensee means a change in the substance of the terms of the agreement.[45] Because of the way § 365 is drafted, once a contract falls under this assignment exception, a question arises as to whether the contract can even be assumed by a debtor in possession.[46] Numerous courts have determined that § 365(c)(1) not only prevents the assignment of executory contracts, but also prevents the assumption and performance of the contract by the debtor itself.[47] The ramifications of these decisions on software license agreements will be discussed later in this Article in Part III.

C. Rejection of Executory Contracts

Just as a DIP/trustee can assume a favorable executory contract, a DIP/trustee may reject any executory contract, subject to the bankruptcy court's approval.[48] Congress added this section to "allow a debtor to maximize its assets by minimizing its

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the [intellectual property],' which 'cannot be assigned unless the intellectual property owner authorizes the assignment. . . .'" (quoting *In re* Patient Educ. Media, 201 B.R. 234, 242–43 (Bankr. S.D.N.Y. 1997))); Perlman v. Catapult Entm't, Inc. (*In re* Catapult Entm't. Inc.), 165 F.3d 747, 750 (9th Cir. 1999) ("our precedents make it clear that federal patent law constitutes 'applicable law' within the meaning of § 365(c), and that nonexclusive patent licenses are 'personal and assignable only with the consent of the licensor.' (quoting Everex Sys. v. Cadtrak Corp. (*In re* CFLC, Inc.), 89 F.3d 673, 680 (9th Cir. 1996))).

[44] *See In re Golden Books Family Entm't*, 269 B.R. at 311.

[45] *See generally* 2-8 MATTHEW BENDER, COMPUTER CONTRACTS § 8.02 (2006) (discussing the application of copyright law to software licenses).

[46] BAIRD, *supra* note 17, at 125–26; *compare* Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489 (1st Cir. 1997), *with Catapult Entm't Inc.*, 165 F.3d 747. *See also* discussion in Part III.

[47] *See* RCI Tech. Corp. v. Sunterra Corp. (*In re* Sunterra Corp.), 361 F.3d 257, 271 (4th Cir. 2004) ("Without RCI's consent, Sunterra was precluded from assuming the Agreement"); *Catapult Entm't. Inc.*, 165 F.3d at 754–55 ("We hold that, where applicable nonbankruptcy law makes an executory contract nonassignable because the identity of the nondebtor party is material, a debtor in possession may not assume the contract absent consent of the nondebtor party."); *In re* W. Elecs. Inc., 852 F.2d 79, 83 (3d Cir. 1988) ("11 U.S.C. § 365(c)(1) creates a hypothetical test—i.e., under the applicable law, could the government refuse performance from 'an entity other than the debtor or the debtor in possession.'").

[48] 11 U.S.C. § 365(a) (2000).

burdensome liabilities."[49] Rejection allows the debtor to notify the other contracting party and the bankruptcy court that it will not continue to perform its contractual obligations, similar in effect to an anticipatory breach of contract.[50] Bankruptcy courts also apply the deferential business judgment rule in reviewing rejections of executory contracts.[51] If the court approves a rejection of an executory contract, the Bankruptcy Code provides that the debtor is deemed to have breached the agreement, giving rise to a pre-petition claim for damages for breach of contract.[52] Essentially, unless the non-debtor has secured collateral for itself, the non-debtor is left with a general unsecured claim against the debtor's estate for contract damages.[53] The Bankruptcy Code bars the remedy of specific performance for a rejected executory contract licensing intellectual property.[54] Rejections of intellectual property licenses when the licensor is the debtor are also complicated by a special provision giving the non-debtor licensee additional choices unavailable to non-debtors in other executory contracts.[55] The consequences of rejection of a software license agreement will be discussed in more detail Article in Part II.

D. The Classification of Software License Agreements in Bankruptcy

In order to decide whether a software license agreement is an executory contract, it is necessary to describe the license's rights and obligations.[56] There are two broad categories of license agreements for the purposes of this discussion: non-exclusive licenses, which grant the licensee the right to make use of the software without restricting the rights of the licensor to grant the

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[49] Walter D. Denson, *The Source Code Escrow: A Worthwhile or Worthless Investment*, 1 RUTGERS BANKR. L.J. 1, 10 (2003).

[50] *See* Daniel T. Brooks, *Intellectual Property Bankruptcy Protection Act of 1988,* 272 PLI/Pat 575, 607 (1988); Denson, *supra* note 49.

[51] *See* Group of Institutional Investors v. Chicago, Milwaukee, St. Paul & Pac. R.R., 318 U.S. 523, 550 (1943).

[52] 11 U.S.C. § 365(g) (2000).

[53] Brooks, *supra* note 50.

[54] 11 U.S.C. § 365(n)(1)(B) (2000).

[55] 11 U.S.C. § 365(n) (2000).

[56] *See* Robert L. Tamietti, *Technology Licenses Under the Bankruptcy Code: A Licensee's Mine Field,* 62 AM. BANKR. L.J. 295, 303 (1988).

same rights to other licensees; and exclusive licenses, which grant a licensee the right to be the only party to use the software.[57]

In general, a nonexclusive software license is more like a rental agreement than a sale.[58] It is a contract in which the licensor agrees to let the licensee use the licensor's software application for a specified period of time and in certain stated ways.[59] The licensee is essentially paying rent to the licensor for use of the licensor's intangible property. The licensor, however, does not transfer ownership of the software, but retains the rights and remedies associated with the intellectual property.[60] Therefore, the license is not considered an assignment of intellectual property.[61] Instead, a non-exclusive license is merely a contractual promise not to sue the licensee.[62] As mentioned in Part I.B above, courts consider most non-exclusive intellectual property licenses to be non-assignable by the licensee without the consent of the licensor.[63]

Exclusive licenses, on the other hand, are more like an assignment or sale than the rental agreement of a nonexclusive license.[64] Similar to an assignment, an exclusive software license is a transfer of copyright ownership.[65] Importantly, unlike a non-exclusive license, exclusive licenses are generally assignable by the licensee, unless the license agreement expressly provides otherwise or the licensor specifically consents to the assignment.[66] The rationale behind this rule is that the terms of a sale do not normally turn on the identity of the buyer. Since the seller is not affected by the agreement after the sale is complete, there is no reliance on the personal services of the buyer/licensor when

57 Kuney, *supra* note 12, at 597.
58 *See id.* at 597–98.
59 *See, e.g.*, BRINSON, *supra* note 15, at 509–10.
60 *See* Kuney, *supra* note 12, at 598.
61 *See* Richard L. Grier et al., *Uniform Computer Information Transaction Act: Bringing Commercial Law into the 21st Century*, 8 RICH. J.L. & TECH. 9, 69 (2001).
62 *In re* CFLC, Inc., 89 F.3d 673, 677 (9th Cir. 1996).
63 11 U.S.C. § 365(c)(1)(B) (2000); *see supra* Part I.B.
64 Kuney, *supra* note 12, at 598.
65 *Id.*
66 H. Ward Classen, *Fundamentals of Software Licensing*, 37 IDEA 1, 10 (1996); *see also In re* Sentry Data, Inc., 87 B.R. 943, 947 (Bankr. N.D. Ill. 1988).

negotiating the terms of the agreement. However, not all exclusive licenses resemble sales of intellectual property.[67] For example, an exclusive license to market the software, often referred to as a software distribution agreement, is arguably a nonassignable license because it is more like a service agreement than a transfer of actual property.[68]

The next step in classifying software license agreements is to decide whether they are executory contracts within the Bankruptcy Code.[69] As with any other contract, this requires an analysis of the continuing obligations of both parties, using the Countryman definition described in Part I.A.[70] Since many patent and copyright licenses contain standard provisions, some courts have simply presumed that intellectual property license agreements are executory without analyzing the nature of the ongoing obligations on both sides of the agreement.[71] Despite broad similarities to patent and copyright licenses, since most software license agreements, especially those that are individually negotiated, have unique provisions and differ in the actual rights and obligations of each party, a better analysis would look at each software license agreement separately and make a decision depending on the existing obligations of each party.[72] The rest of this section will look at common obligations contained in a typical software license agreement in an attempt to allow a drafter to predict whether a contract will be classified as executory based on the continuing obligations imposed by the agreement.

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[67] *See, e.g.*, BRINSON, *supra* note 15, at 510.

[68] Classen, *supra* note 66; *see also In re* Sentry Data, Inc., 87 B.R. 943, 947 (Bankr. N.D. Ill. 1988).

[69] BAIRD, *supra* note 17, at 109.

[70] *Id.*

[71] *See, e.g.*, 75 RCC Tech. Corp. v. Sunterra Corp., 287 B.R. 864, 865 (Bankr. D. Md. 2003) (noting without analysis that "there is a long line of authority holding that intellectual property licensing agreements such as the SLA [Software License Agreement] are executory contracts."), *rev'd for other reasons*, 361 F.3d 257 (4th Cir. 2004); *In re* Golden Books Family Entm't, Inc., 269 B.R. 300, 308–09 (Bankr. D. Del. 2001); *In re* Patient Educ. Media, Inc., 210 B.R. 237, 241 (Bankr. S.D.N.Y. 1999).

[72] *See In re* Learning Publ'ns, Inc., 94 B.R. 763, 765 (Bankr. M.D. Fla. 1988); *In re* Stein , Inc., 81 B.R. 263, 267 (Bankr. S.D.N.Y. 1988).

E. *Common Obligations of a Software License Agreement and Its Resulting Classification as an Executory Contract*

Although sometimes presumptively classified as non-executory, even exclusive licenses, which represent a more complete conveyance of rights than non-exclusive licenses, sometimes include significant ongoing contractual obligations and therefore can be classified as executory contracts.[73] In *Rudaw*, for example, an exclusive transfer of copyright ownership was considered executory when the debtor filed for bankruptcy before the buyer completed all the installment payments for the software.[74]

However, when the licensor bears little or no continuing obligations and the agreement has further attributes of a sale, for instance payment by lump sum, the agreement is better viewed as non-executory.[75] In fact, even though the parties to the agreement may intend a non-exclusive license agreement and add labels to the contract consistent with such a license, if the function of the contract looks more like a sale, with substantial performance completed at the outset of the contract, the court will look beyond the intent to find the agreement non-executory.[76]

Clearly, significant continuing obligations, would also cause a non-exclusive license to be classified as executory.[77] A more

[73] *In re* Rudaw/Empirical Software Prods. Ltd., 83 B.R. 241, 246 (Bankr. S.D.N.Y. 1988).

[74] *Id.* at 243–46.

[75] *In re* Stein, 81 B.R. 263, 266–67 (Bankr. S.D.N.Y. 1988); *In re* Monument Record Corp., 61 B.R. 866, 868–69 (Bankr. M.D. Tenn. 1986).

[76] Microsoft Corp. v. Dak Indus., Inc. (*In re* DAK Indus., Inc.), 66 F.3d 1091, 1095 n.2 (9th Cir. 1995) (holding a bilateral "License Agreement" granting DAK nonexclusive, worldwide license rights to distribute Microsoft's Word for Windows software program on its computer systems to be a lump sum sale of software units based on (1) the pricing and timing of the payments which was a lump sum paid at the outset of the agreement regardless of how many units it sold; (2) the licensee received all of its rights at the beginning of the agreement; (3) the agreement did not simply permit the debtor to use the technology, but permitted the debtor to sell the technology; and (4) at the time the agreement commenced, Microsoft delivered the master disk from which the copies were to be made and therefore had substantially completed its performance at the outset of the contract).

[77] Some examples of common continuing obligations are a continuing obligation to account for and pay royalties, duties of notice, responsibilities relating to reporting,

difficult question in terms of non-exclusive licenses, however, is whether the licensor's implied contractual promise not to sue the licensee for infringement by itself represents an independent obligation that can support the classification of the contract as executory. Several cases do classify contracts with such obligations as executory.[78] However, other courts, examining the nature of intellectual property rights, have held otherwise.[79] In addition, a license with only continuing obligations of confidentiality by both parties to the license has been considered executory.[80] However, a license is not executory simply because it obligates one party to make payments of money to the other.[81] Provisions that constitute mere covenants that, if not followed, might relieve the other contracting party of continuing performance, but would not amount to breach of the contract, also do not lead to a definition of executory.[82]

The practical result of the above summary is that each software license must be analyzed individually, taking into account all the obligations owed by each party, to decide whether that particular contract will be considered executory by a bankruptcy court.[83] The rest of this Article, while exploring several specific bankruptcy issues that should be anticipated by drafters of software license agreements, will examine several prominent cases. These cases also provide illustrations of software license agreements that have been found executory and allow a practitioner to make an educated

labeling, policing, service, and maintenance, refraining from licensing to others, and obligations to provide product upgrades. *See, e.g.*, Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc. *(In re* Richmond Metal Finishers, Inc.), 756 F.2d 1043, 1045 (4th Cir. 1985); Fenix Cattle Co. v. Silver (*In re* Select-A-Seat Corp.), 625 F.2d 290, 292 (9th Cir. 1980).

78 *E.g.*, *In re* Golden Books Family Entm't Inc., 269 B.R. 300, 309 (Bankr. D. Del. 2001); *In re* Access Beyond Techs. Inc., 237 B.R. 32, 43 (Bankr. D. Del. 1999); Everex Sys., Inc. v. Cadtrak Corp. (*In re* CFLC, Inc.), 89 F.3d 673 (9th Cir. 1996).

79 *See In re* Gencor Indus., Inc., 298 B.R. 902, 907 (Bankr. M.D. Fla. 2003).

80 RCI Tech. Corp. v. Sunterra Corp. (*In re* Sunterra Corp.), 361 F.3d 257, 264 (4th Cir. 2004).

81 *See Lubrizol*, 756 F.2d at 1046, citing H.R. REP. NO. 95-595.

82 *In re* Gencor Indus., Inc., 298 B.R. 902 (Bankr. M.D. Fla. 2003) (finding that Most Favored Nations Clause and Patent Defense Clause of licensing agreement were mere conditions of payment by the licensee, whose failure would excuse further payment, rather than material continuing obligations whose failure would breach the contract).

83 *See, e.g.*, BRINSON, *supra* note 15, at 525–26.

guess about the status of a pending contract.[84] Since the line between executory and non-executory is sometimes unclear, a prudent drafter should anticipate either conclusion and plan accordingly.[85]

II. ISSUES FACING A LICENSEE WHEN THE DEBTOR IS A LICENSOR

Many companies license software from software vendors to facilitate their business, either relying on the licensed software for internal purposes, such as data processing and accounting, or to assist in the creation of their actual product.[86] Often, once software is licensed and brought into the company, the business relies on that software, which becomes an integral part of the business process.[87] Replacing that software is often extremely expensive even if it just requires retraining of the employees that use it.[88] In addition, the licensee is usually dependent on the licensor to correct any bugs or defects in the software, as well as to perform any necessary maintenance on the software.[89] Consequently, software license agreements are often accompanied by a "maintenance" agreement, which requires the licensor to update, debug, and maintain the software for the term of the contract.[90]

The software licensee, therefore, has a significant interest in making sure its license endures for the entire duration of the agreement.[91] In a controversial 1985 case, *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*,[92] however, the Fourth

84 *See, e.g.*, *Lubrizol*, 756 F.2d at 1046.

85 *See* Michelle Morgan Harner et al., *Debtors Beware: The Expanding Universe of Non-Assumable/Non-Assignable Contracts in Bankruptcy*, 13 AM. BANKR. INST. L. REV. 187, 189 (2005); 3-27 MILGRIM ON LICENSING § 27.13.

86 *See* Jonathan L. Mezrich, *Source Code Escrow: An Exercise in Futility?*, 5 MARQ. INTELL. PROP. L. REV. 117, 117–18 (2001).

87 *Id.*

88 *See id.*

89 *Id.*

90 Gres, *supra* note 1, at 363–64.

91 *See* Richard M. Cieri, et. al., *Protecting Technology and Intellectual Property Rights When a Debtor Infringes on Those Rights*, 8 AM. BANKR. INST. L. REV. 349, 355 (2000).

92 Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043 (4th Cir. 1985), *cert. denied*, 475 U.S. 1057 (1986).

Circuit found that a technology license agreement was an executory contract rejectable by the licensor-debtor under § 365(a).[93] In the context of a licensee who depends on the licensor for maintenance of software critical to their business, the rejection by the licensor can be devastating.[94] It requires the licensee to either stop using the software altogether and replace it with something else, or instead to renegotiate a new license with the licensor who can essentially hold-out for an inflated price.[95] Although *Lubrizol* involved a technology license rather than a software license agreement, after it was decided, a number of commentators warned that software license agreements would also be treated as rejectable executory contracts in the bankruptcy of a software licensor.[96]

A. *Lubrizol Enterprises and Select-A-Seat*

The agreement at issue in *Lubrizol* was a nonexclusive right to use the debtor's technology.[97] Although the license was executed and the instruction manuals were delivered to Lubrizol before bankruptcy, the bankruptcy court held this was an executory contract and that attempts at new licensing of the technology, the debtor's principal asset in its Chapter 11 reorganization, were hindered by the existing license.[98] Under the agreement, the debtor's continuing duties were: 1) to notify Lubrizol about any claims of the licensed technology infringing another's patent; 2) to defend the licensee Lubrizol in any patent infringement suit; 3) to hold Lubrizol harmless from certain losses; and 4) to notify Lubrizol of any licenses granted.[99] Lubrizol had continuing contractual obligations to: 1) account for and pay the licensor royalties for the use of the licensed technology process; and 2) pay

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[93] *See id.* at 1047.
[94] Cieri, *supra* note 91, at 355.
[95] Gres, *supra* note 1, at 364–65.
[96] *See, e.g.*, BRINSON, *supra* note 15, at 520; James E. Meadows, *Lubrizol: What Will It Mean for the Software Industry*, 3 SANTA CLARA COMPUTER & HIGH TECH. L.J. 311 (1987); Gres, *supra* note 1, at 365–66.
[97] *In re* Richmond Metal Finishers, Inc., 34 B.R. 521, 522 (Bankr. E.D. Va. 1983).
[98] *Id.* at 525.
[99] *Id.* at 524.

off other existing debts.[100] According to the bankruptcy court, these obligations, even if contingent, were important aspects of the consideration given by the licensor to Lubrizol, and therefore could be sufficient to make the contract executory.[101]

The district court disagreed with the bankruptcy court, finding the technology license agreement non-executory and noting that general warranties are not enough of a continuing obligation on which to base a finding of an executory contract.[102] In addition, the court assumed that even if Richmond was allowed to reject the license, this rejection would not affect Lubrizol's ability to use the technology or relieve Lubrizol of its obligation to pay royalties.[103] The district court did not think that it had the "power, in a summary proceeding, to strip Lubrizol of the intellectual property it had purchased from Richmond."[104]

The court of appeals reversed the district court's decision, finding, like the bankruptcy court, that Richmond's continuing duties to licensee Lubrizol and Lubrizol's duty of accounting for and paying royalties were sufficient to make the contract executory.[105] In addition to relieving the licensor estate of future performance obligations under the license, the *Lubrizol* decision, disagreeing with the district court's assumption, also gave the licensor a complete rescission of the technology transfer.[106] This aspect of the *Lubrizol* decision was predicted to be especially disastrous for software licensees because it revealed the possibility that a licensee could lose all rights to licensed software should the licensor file bankruptcy.[107]

In fact, just five years earlier, in *In re Select-A-Seat*, the Ninth Circuit also held that an exclusive software distribution and use

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[100] *Id.*
[101] *Id.*
[102] *In re* Richmond Metal Finishers, Inc., 38 B.R. 341, 344 (E.D. Va. 1984).
[103] *Id.*
[104] *Id.*
[105] Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043, 1045–46 (4th Cir. 1985).
[106] Stuart Moskowitz, *Intellectual Property Licenses In Bankruptcy: New 'Veto Power' For Licensees Under Section 365(n)*, 44 BUS. LAW. 771, 780 (1989); *see Lubrizol*, 756 F.2d at 1048.
[107] Moskowitz, *supra* note 106.

license was a rejectable executory contract.[108] However, in *Select-A-Seat*, the debtor's trustee sought only to reject the debtor-licensor's continuing warranties of title and fitness for purpose and the agreement's exclusive-dealing obligation.[109] Unlike the total forfeit of use rights by the licensee in *Lubrizol*, the court allowed the former exclusive licensee to continue using and selling the licensed software on a nonexclusive basis.[110] In comparison, the entire rescission aspect of *Lubrizol* held that the licensee's right to use the licensed technology terminated when the license agreement was rejected in the licensor's bankruptcy, leaving the licensee with only a claim for damages for breach of contract.[111]

After the *Lubrizol* decision, the intellectual property community's fear that it was powerless to protect licensees from licensor bankruptcy proceedings, resulted in Congressional amendments to § 365, commonly known as the Intellectual Property Bankruptcy Protection Act of 1987 ("IPLBA").[112] Congress's intent in passing this amendment was to protect licensees' rights to intellectual property in the event of a bankruptcy.[113]

B. *The Congressional Response to Lubrizol and § 365(n)*

The IPLBA was codified in § 365(n), allowing a licensee to retain its use right in licensed intellectual property even if the licensor rejects the license agreement in bankruptcy.[114] Under § 365(n), licensees have two choices when the licensor rejects their license while in bankruptcy. First, the licensee may elect to treat

[108] Fenix Cattle Co. v. Silver (*In re* Select-A-Seat Corp.), 625 F.2d 290, 292–93 (9th Cir. 1980).
[109] *Id.* at 292.
[110] *Id.*
[111] *Lubrizol*, 756 F.2d 1048.
[112] Intellectual Property Bankruptcy Act (IPLBA) of 1987, Pub. L. No. 100-506, 102 Stat. 2538 (1988) (codified at 11 U.S.C. § 365(n)); *see* John P. Musone, *Crystallizing the Intellectual Property Licenses In Bankruptcy Act: A Proposed Solution To Achieve Congress' Intent*, 13 EMORY BANKR. DEV. J. 509, 509 n.3 (1997).
[113] S. REP. NO. 100-505, at 1–5 (1988), *as reprinted in* 1988 U.S.C.C.A.N. 3200, 3207 (explaining that the purpose is "to make clear that the rights of an intellectual property licensee to use the licensed property cannot be unilaterally cut off as a result of the rejection of the license . . . ."); *see* 11 U.S.C. § 365(n)(2000).
[114] *See* 11 U.S.C. § 365(n).

the license as terminated and assert a claim for breach of contract damages.[115] More importantly, the licensee may elect to retain its licensed rights in the intellectual property for the duration of the contract.[116] If the licensee chooses the second option, it must continue to make all royalty payments due to the debtor under the license agreement.[117] The debtor, however, will have "no obligation to the licensee after rejection other than to grant the licensee unimpeded use of the technology."[118]

C. *Lubrizol* Problems That Persist after the IPLBA

Although the IPBLA amended § 365(n) in response to *Lubrizol*, it did not fix all of the problems brought to light by that decision. First, it did not clarify the confusion over what it means to reject a contract in bankruptcy.[119] Second, it did not give any guidance to the courts on how to resolve what is to happen to a licensee when a licensor attempts a free and clear sale in bankruptcy under § 363.[120]

1. What Does It Mean to Reject a Software License in Bankruptcy?

As mentioned in Part I.C above, a trustee can reject an executory contract under the Code.[121] There appears to be confusion in the courts, however, including the *Lubrizol* court, on what is the "effect" of rejecting a contract using § 365.[122] A rejection is simply an election to breach which does not cause the contract to go away or constitute rescission.[123] However, some courts treat rejection as a species of an avoidance, giving creditors

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[115] *Id.* § 365(n)(1)(A).
[116] *Id.* § 365(n)(1)(B).
[117] *Id.* § 365(n)(2).
[118] Cieri, *supra* note 91, 355–56; *see also* 11 U.S.C. § 365(n)(3).
[119] BAIRD, *supra* note 17, at 109.
[120] Robert M. Zinman, *Precision in Statutory Drafting: The Qualitech Quagmire and the Sad History of 365(h) of the Bankruptcy Code*, 38 J. MARSHALL L. REV 97, 100 (2004).
[121] 11 U.S.C. § 365(a) (2000).
[122] *See* Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043, 1048 (4th Cir. 1985).
[123] BAIRD, *supra* note 17, at 112.

inside of bankruptcy something they would not have had outside bankruptcy.[124] In *Lubrizol*, for example, the district court assumed that rejection did not restrict Lubrizol, the licensee, from using the technology already in its possession.[125] The bankruptcy and appeals courts assumed just the opposite; they treated the rejection as an avoidance of the entire contract, placing the parties in the position they would be in if the contract had never been entered.[126] However, nothing about the nature of rejection requires that the trustee be able to undo a property transfer.[127] In fact, for real property, the code explicitly states that rejection simply follows applicable non-bankruptcy law, and does nothing to dispossess the licensee of real property.[128] The trustee can reject the real property lease and free the debtor's estate from any ongoing obligations, but the trustee cannot undo the lease entirely while the lessee is still in possession of the property.[129]

Section 365(n)(1)(B) of the Bankruptcy Code does limit the protection afforded to the licensee's § 365(n) intellectual property rights to those that existed immediately before the licensor's bankruptcy case commenced.[130] If the licensee elects to retain its rights under § 365(n), they are permitted to enforce only the passive obligations of the licensor.[131] The licensee cannot require specific performance of other obligations included in the license, such as service provisions by the licensor.[132] Of course, the licensee would have claims against the bankruptcy estate for any of these service provisions, such as obligations of the licensor to provide maintenance and upgrades.[133] However, unlike § 365(h),

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124 *Id*.
125 756 F.2d at 1048.
126 *See id.*
127 BAIRD, *supra* note 17, at 114.
128 11 U.S.C. § 365(h)(1)(A) (2000); *see also* BAIRD, *supra* note 17, at 114.
129 *See* 11 U.S.C. § 365(h); *see also* BAIRD, *supra* note 17, at 114.
130 11 U.S.C. § 365(n)(1)(B).
131 *Id.*
132 *Id*. *See also* Madlyn Gleich Primoff et. al., *E-Commerce and Dot-Com Bankruptcies: Assumption, Assignment and Rejection of Executory Contracts, Including Intellectual Property Agreements, and Related Issues Under Section 365(c), 365(e) and 365(n) of the Bankruptcy code*, 8 AM. BANKR. INST. L. REV. 307, 342 (2000).
133 BAIRD, *supra* note 17, at 116.

§ 365(n) does not explicitly state what rejection means for any technology already being used by the licensee.[134]

Commentators disagree about whether the rule for rejection of all technology licenses should mirror that of a traditional real property lease.[135] However, the specific rules governing technology licenses in § 365(n) are similar to those governing real property in § 365(h), leading to the conclusion that the results of rejection should be the same.[136] There is no bankruptcy reason to override applicable non-bankruptcy law and allow the trustee the power to recapture rights they could not outside bankruptcy.[137] The correct view should be that "rejection of executory aspects of a contract does not bring about a rescission of property transfers completed prior to bankruptcy."[138]

2. What Is the Effect of a Debtor-Licensor § 363 Free and Clear Sale?

Another question left open by the addition of § 365(n) is how to reconcile this provision with § 363(f).[139] Section 363(f) authorizes a "free and clear sale," allowing the sale of a debtor's property free of any "interest" other than the estate's.[140] If a free and clear sale of the underlying technology is held to trump the § 365(n) protection given to technology licensees, then such a sale will extinguish the licensee's rights to use the licensed technology,

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[134] 11 U.S.C. § 365(n) (2000).

[135] *Compare* BAIRD, *supra* note 17, at 118, *with* BRINSON, *supra* note 15, at 529.

[136] *See, e.g.*, BAIRD, *supra* note 17, at 120–21.

[137] *Id*. at 120.

[138] BRINSON, *supra* note 15, at 529.

[139] 11 U.S.C. § 363(f):

> The trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate, only if—
> (1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;
> (2) such entity consents;
> (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
> (4) such interest is in bona fide dispute; or
> (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

[140] 11 U.S.C. § 363(f); Precision Indus., Inc. v. Qualitech Steel (*In re* Qualitech Steel Corp.), 327 F.3d 537, 540 (7th Cir. 2003).

just as in the *Lubrizol* case.[141] While there are relatively few cases deciding this issue, in 2003 the Seventh Circuit decided that for the analogous executory contract protection for property leases, § 365(h), a free and clear sale of the underlying real property does in fact trump the § 365(h) statutory protection to leases.[142]

As in *Lubrizol*, the district court in *Qualitech* disagreed with both the bankruptcy and the appeals courts.[143] The district court concluded that § 365(h) trumped the free and clear sale because of the specific terms of § 365(h)(1)(A)(ii) expressly stating that a non-debtor lessee may elect to retain possession of the property after a rejection of an unexpired lease thus allowing the lessee to remain in possession of the property even in the face of the § 363 sale.[144] The district court also looked to the legislative history of § 365(h) and found that the intent of Congress was to preserve the lessee's estate.[145] Finally, the district court noted that § 365(h) does not reference any other provision of the Bankruptcy Code as a limitation.[146]

The Seventh Circuit overruled the district court, using statutory construction to decide that a free and clear sale does trump § 365(h)'s protection of the lessee's possessory interest in the sold property.[147] The court interpreted the term "any interest" as used in § 363(f) as being sufficiently broad to include the lessee's interest as a lessee.[148] Since, § 363(f) standing alone permits the sale of the property free and clear of a lessee's possessory interest, the court concluded that § 365(h) can only protect the lessee if it supersedes the free and clear sale.[149] However, because neither section contains any limiting cross-section, and § 365(h)(1)(A) is limited to when an unexpired lease is *rejected*, but does not mention *sale*, the court held that § 365(h) does not supersede the

141 *See In re Qualitech Steel Corp.*, 327 F.3d at 540.
142 *Id.*
143 Precision Indus., Inc. v. Qualitech Steel (*In re* Qualitech Steel Corp.), 2001 U.S. Dist. LEXIS 8328 (S.D. Ind. 2001).
144 *Id.* at *14.
145 *Id.* at *37.
146 *Id.* at *46.
147 *In re Qualitech Steel Corp.*, 327 F.3d at 540.
148 *Id.* at 545.
149 *Id.* at 546–47.

free and clear sale.[150] In addition, the court noted that § 363 itself provides for the requirement of adequate protection to any entity with an interest in the property to be sold, here the lessee.[151] Holding that this adequate protection can be provided in the form of compensation as opposed to a continued possessory interest in the property, the court held that this right to compensation was adequate protection for the lessee.[152]

This Seventh Circuit decision has caused great concern in the real estate investment community because it allows a landlord in bankruptcy to ignore the protections given by § 365(h) potentially resulting in a disruption in leasehold investments.[153] Since *Qualitech* does apply normal rules of statutory interpretation, and may therefore be followed by other courts, it has resulted in an urge to Congress to address these complications in the statute.[154] One caveat to *Qualitech* that may prove helpful to future lessees is that the lessee in the case did not object, as was their right under § 363, to the free and clear sale.[155] There is no way to predict what would have happened if the lessee had filed an objection at the time the sale was proposed.[156]

Although *Qualitech* concerned a real property lease and § 365(h) as opposed to a technology license and § 365(n), since the *Qualitech* court's analysis would be equally applicable to the § 365(n) protection of technology licensees, those rights and interests may also be at risk in a free and clear sale.[157]

150 *Id.* at 547.
151 *Id.* at 548.
152 *Id.*
153 Zinman, *supra* note 120, at 100.
154 *Id.* at 100–01.
155 *In re Qualitech Steel Corp.*, 327 F.3d at 541.
156 Peter N. Tamposi, *Tenants Beware—Your Lease Rights May Be Subject to Termination by the Bankruptcy Court: Licensees of Intellectual Property Take Note: You May Be Next*, 22-8 AM. BANKR. INST. J. 30 (2003).
157 *Id.* at 30.

III. ISSUES FACING A LICENSEE WHEN THEY ARE ALSO THE DEBTOR

The *Lubrizol* case, as demonstrated above, highlighted the problem of rejection by a debtor-licensor depriving a licensee of rights negotiated pre-bankruptcy. A similar loss of contractual rights can arise when the licensee in a software license agreement files for bankruptcy and the licensor refuses to consent to an assignment of the license by the reorganized debtor in possession.

A. Section 365 and the Hypothetical versus the Actual Test

As discussed in Section IB and C above, § 365 gives a trustee, or debtor in possession, the authority to assume, assign or reject the executory contracts of the debtor, notwithstanding any contrary provisions appearing in such contracts.[158] Section 365(c), however, contains an exception to this general rule, prohibiting a debtor from assuming or assigning an executory contract if "applicable law" excuses the non-debtor party from accepting performance from anyone other than the original contract party.[159] These rules develop from a straightforward reading of § 365(c).

Confusion arises, however, when § 365(c)(1) is read together with § 365(f).[160] Section 365(f) permits a debtor to assume and assign an executory contract to a third party.[161] Before assignment to a third party, the debtor must first assume the contract and provide the non-debtor party adequate assurance of future performance by the proposed assignee.[162] Since § 365(f) contains

158 11 U.S.C. § 365(a) (2000); Perlman v. Catapult Entm't, Inc. (*In re* Catapult Entm't. Inc.), 165 F.3d 747, 749 (9th Cir. 1999).
159 11 U.S.C. § 365(c); Harner, *supra* note 85, at 197.
160 Harner, *supra* note 85, at 197.
161 11 U.S.C. § 365(f)(1) ("Except as provided in subsection[] . . . (c) of this section, notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease . . . .").
162 11 U.S.C. § 365(f)(2)(A) ("The trustee may assign an executory contract or unexpired lease of the debtor only if . . . the trustee assumes such contract or lease in accordance with the provisions of this section . . . ."); § 365(f)(2)(B) ("The trustee may assign an executory contract or unexpired lease of the debtor only if . . . adequate assurance of future performance by the assignee of such contract or lease is provided, whether or not there has been a default in such contract or lease.").

the provision "notwithstanding a provision in [the] executory contract or unexpired lease of the debtor, *or in applicable law*, that prohibits, restricts, or conditions the assignment of such contract or lease," the two sections seem to conflict if "applicable" law excuses a non-debtor party from accepting the performance of a third party assignee.[163] In this situation, § 365(c)(1) would prevent both assumption and assignment of the contract, while § 365(f) would permit such assumption and assignment.[164] Even more problematic is what a court should do in the case that applicable law prohibits assignment, but the debtor is seeking only to assume and not assign the executory contract.[165]

While some courts attempt to resolve this apparent conflict by interpreting the term "applicable law" differently in § 365(c)(1) and § 365(f),[166] most courts give effect to § 365(c)(1) when the executory contract is for personal services.[167] If a debtor in possession seeks to assume a license for the benefit of a reorganized debtor, but that license is considered a personal services contract preventing such assumption, the licensor is put in a position of extraordinary power over the debtor-licensee, especially if the technology licensed by the executory contract is critical for the survival of the reorganized debtor.[168] The licensor will be able to hold-out for significant price increases and, similar to the licensor-debtor in a *Lubrizol*-type situation, can extract exorbitant fees to allow the licensee merely to retain its bargained-for benefit.[169]

So, the answer to the question of whether § 365(c)(1) or § 365(f) reigns when the debtor-licensee attempts to assume a license has vital importance to the survival of the reorganized

163 Harner, *supra* note 85, at 197.
164 11 U.S.C. § 365(c)(1)(A) (2000); 11 U.S.C. § 365(f).
165 *See id.*
166 *See, e.g.*, RCI Tech. Corp. v. Sunterra Corp. (*In re* Sunterra Corp.), 361 F.3d 257, 266 (4th Cir. 2004).
167 *See, e.g.*, Perlman v. Catapult Entm't, Inc. (*In re* Catapult Entm't. Inc.), 165 F.3d 747, 752 (9th Cir. 1999); *In re* James Cable Partners, L.P., 27 F.3d 534, 538 (11th Cir. 1994); *In re* Magness, 972 F.2d 689, 695 (6th Cir. 1992).
168 *See* Harner, *supra* note 85, at 233–35.
169 *See generally id.* (describing the consequences of § 365(c)(1), where a debtor wishes to assume an executory contract and applicable nonbankruptcy law restricts assignment).

debtor.[170] Currently, the courts are split between two tests for determining the answer to this question.[171] The first test, the hypothetical test, prohibits a debtor from assuming an executory contract over the non-debtor's objection "if applicable law would bar assignment to a hypothetical third party, even where the debtor in possession has no intention of assigning the contract in question to any such third party."[172] The second test, the actual test, only prohibits the assignment of an executory contract if the debtor *actually* seeks to assign the contract.[173] The actual test thus allows the debtor-licensee to retain its contractual benefit as long as it does not also attempt to assign that benefit to a third party and will be the test preferred by licensees.

B. Catapult Entertainment and Sunterra Corporation

Unfortunately, many courts have opted for the hypothetical test when dealing with technology licenses.[174] For example, in *Catapult*, a patent licensor attempted to bar a debtor/licensee from assuming patent licenses as part of its Chapter 11 reorganization.[175] While the bankruptcy and district courts approved the assumption as part of the confirmed reorganization plan, the Ninth Circuit reversed, using the hypothetical test to hold that § 365(c)(1) barred the licensee from assuming the licenses.[176] The *Catapult* court stated that "where applicable non-bankruptcy law makes an executory contract non-assignable because the identity of the non-debtor party is material, a debtor in possession may not assume the contract absent consent of the nondebtor party."[177]

In addition, the Fourth Circuit adopted the equivalent of the hypothetical test for software licenses in *In re Sunterra*

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170 *Id.*

171 *Id.*

172 Perlman v. Catapult Entm't, Inc. (*In re* Catapult Entm't, Inc.), 165 F.3d 747, 750 (9th Cir. 1999).

173 Harner, *supra* note 159, at 235.

174 *See, e.g.*, *In re* Catapult Entm't, Inc., 165 F.3d at 748; RCI Tech. Corp. v. Sunterra Corp. (*In re* Sunterra Corp.), 361 F.3d 257, 262 (4th Cir. 2004).

175 *In re* Catapult Entm't, Inc., 165 F.3d at 749.

176 *Id.* at 749–51.

177 *Id.* at 754–55.

Corporation.[178] In *Sunterra*, the licensee was a resort management that entered into a non-exclusive license to use software from RCI, the licensor, for functions such as recording reservations, managing resort properties, and marketing and financing timeshares.[179] In addition to basing its internal operations on the licensed software, Sunterra, the licensee, invested large amounts of capital into the licensed system by developing its own software enhancements, which Sunterra then owned under the license agreement.[180] "[T]he bankruptcy court confirmed Sunterra's plan of reorganization" finding that the RCI license agreement was *not* an executory contract, and even if it were, the actual test allowed the assumption of the agreement since Sunterra did not intend to assign it to a third party.[181] The bankruptcy court reasoned that RCI would not be damaged if Sunterra, as debtor in possession, "assumed the very contract rights it had possessed prior to bankruptcy."[182]

The district court agreed with the bankruptcy court's ultimate assumption decision, but disagreed with the finding that the license was non-executory.[183] The district court assumed the license was executory because "there is a long line of authority holding that intellectual property licensing agreements . . . are executory contracts."[184] Although it was an executory contract, the district court did agree that Sunterra could assume the license by applying the actual test.[185]

The Fourth Circuit, on appeal, found the license to be an executory contract using the "Countryman Test" of executory contract, because at the time of the bankruptcy each party owed the

178 *In re Sunterra Corp.*, 361 F.3d at 262.
179 *Id.* at 260.
180 *Id.* at 261.
181 *Id.*
182 *Id.* at 261–62.
183 *Id.* at 262.
184 RCC Tech. Corp. v. Sunterra Corp., 287 B.R. 864, 865 (D. Md. 2003) (citing *In re* CFLC, Inc., 89 F.3d 673, 677 (9th Cir. 1996)); *see also In re Access Beyond Techs., Inc.*, 237 B.R. 32, 43–44 (Bankr. D. Del. 1999).
185 *In re Sunterra*, 261 F.3d at 263; *RCC Tech. Corp.*, 278 B.R. at 866.

other an ongoing obligation of confidentiality.[186] In addition, the court adopted the hypothetical test and held that Sunterra was precluded from assuming the license because "no matter how appealing" the actual test would be from a policy standpoint, the plain language required the use of the hypothetical test.[187]

Sunterra, who standardized its internal operations on licensed software, invested large amounts of capital in customizing that software, and even owned the enhancements it created, was deprived of any use of that software in its reorganization unless given explicit consent by the licensor.[188] This outcome is just another example of how the current bankruptcy code insufficiently protects licenses.[189] The consequences for licensees who lose all their contractual rights in bankruptcy are exceedingly harsh.[190] The hypothetical test makes the license of the debtor-licensee completely void.[191] In addition, in cases where the licensed software is embedded within hardware, the application of § 365(c)(1) can lead to the prohibition of the simple selling off of a debtor's assets.[192] For instance, if a trustee wants to sell off a router with a ROM embedded with licensed software, the trustee would be precluded from selling unless the licensor agreed to the sale. The licensor thus can use withholding his consent to effectively extort the licensee.[193]

186 *Id.* at 264. The Countryman Test provides that a contract is executory if the "obligation 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." Countryman, *supra* note 31, at 460.
187 *Id.* at 269.
188 *Id.* at 260.
189 Sommer Nicole Louie, *The Inadequacy of Bankruptcy Protection for the Biotechnology Industry*, 22 BANK. DEV. J. 337, 362 (2005).
190 *Id.* at 365.
191 *Id.* at 361.
192 *Cf. In re* Pathnet, 2002 Bankr. LEXIS 1262 (Bankr. E.D. Va. 2002).
193 *Cf.* Zinman, *supra* note 120, at 159–60 (explaining the potential stranglehold a tenant has over a debtor by being able to sell the property regardless of any anti-assignment provisions).

IV. ISSUES FACING A LICENSOR WHEN THE DEBTOR IS A LICENSEE

Licensors also should plan for the possible bankruptcy of the licensee when drafting the license agreement. In general, the advantages given to a licensee in bankruptcy, described above, will work as a constraint on the licensor. A licensor may prefer to terminate any license with any licensee who files for bankruptcy, but it is not as easy as simply providing for termination of the contract upon either party's filing of a bankruptcy petition in the license agreement. Under the Bankruptcy Code, these clauses are called "ipso facto" or bankruptcy clauses, and have no effect.[194] A debtor's property interest becomes property of the estate notwithstanding a provision in the license agreement that "is conditioned on the insolvency or financial condition of the debtor, [or] on the commencement of a case under this title . . . , and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property" upon the commencement of bankruptcy.[195] Also, as opposed to the protection given to technology licensees, the IPLBA does not extend any special protection to licensors whose licensees file for bankruptcy.[196]

A. Rejection, Assumption, and Assignment by the Licensee

When the licensee is in bankruptcy, as mentioned above, as a debtor, the licensee will have three options with regard to the license agreement—rejection, assumption, and assumption and assignment.[197] If the licensee chooses to reject the license, the licensor will lose any anticipated revenues and any expected performance still due by the licensee.[198] The licensor will have a claim on the debtor's estate for the breach of the agreement; however, this will usually bring in only a small percentage of the actual damages.[199]

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[194] 11 U.S.C. § 541(c)(1) (2000); *see also* BRINSON, *supra* note 15, at 527.
[195] 11 U.S.C. § 541(c)(1).
[196] *See* 11 U.S.C. § 365(n).
[197] *See* 11 U.S.C. § 365.
[198] BRINSON, *supra* note 15, at 528.
[199] *Id.*

If the licensee decides to assume the executory license, the licensor may have other problems. First, although the assumption is a new promise to perform, the entity now making this promise is under the constraints of the bankruptcy process and the licensor may see this as an increased business risk.[200] If the licensee has not actually breached the contract at the time of its bankruptcy filing, there is no requirement of any adequate assurance of future performance.[201] In addition, even if there is a breach, which would allow the licensor to terminate the agreement outside of bankruptcy, the licensee can instead choose to cure the breach and give adequate assurance of future performance.[202] The court gets to decide what is acceptable adequate assurance, even if the licensor does not agree.[203]

In addition, as described above, a licensor will have a hard time predicting when a court will find a software license assumable.[204] First, there is the question of whether the hypothetical or actual test will be used to decide if assumption only will be allowed.[205] Second, since a software license is not a pure patent or copyright license, there is some risk that a court will find that software licenses are not personal contracts and that, therefore, applicable law does not prevent their assignment to a third party.[206] In fact, even Vern Countryman, the author of the current executory contract definition, finds the notion that even pure patent licenses are all personal services contracts and thus blocked from assignability as "too mechanical" an analysis.[207] If a court finds the software license validly assignable under applicable law, the licensor could find itself in a position of licensing its technology to a third party it objects to, including possibly a competitor.[208]

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[200] *Id.* at 530.
[201] *Id.* at 531.
[202] *Id.*
[203] *Id.*
[204] *See supra* Part III.
[205] *See supra* notes 169–87 and accompanying text in Part III.B.
[206] BRINSON, *supra* note 15, at 531–32.
[207] *Id.* at 534; Vern Countryman, *Executory Contracts in Bankruptcy: Part II*, 58 MINN. L. REV. 479, 503 (1974).
[208] *See* BRINSON, *supra* note 15, at 534.

B. The Assignability of Software License Agreements

For example, in *In re Sentry Data*,[209] a bankruptcy court found that a software license and distribution agreement was assignable because applicable law allowed the assignment in the absence of a specific contract provision prohibiting such assignment.[210] In this case, Sentry, a software vendor, was the licensor and did not want to allow an assignment by the licensee.[211] Since the court found that the contract made no express or implied reference to personal services, to marketing best efforts, or to any prohibition on assignment, the contract was assignable.[212] Important to this determination was the fact that the contract included a provision permitting sublicensing suggesting that Sentry did not intend to restrict the license to a particular entity.[213] The court did not even mention the presumption of intellectual property licenses as unassignable personal services contracts.[214]

In *Institut Pasteur v. Cambridge Biotech Corp.*,[215] the parties had cross-license agreements for non-exclusive perpetual licenses.[216] Each cross-license included a broad prohibition on assignment or sublicensing, but allowed the benefits of the cross-licenses to be extended to affiliated companies.[217] When Cambridge Biotech ("CBC") filed for bankruptcy, it proposed to assume the cross-licenses and then sell all its stock and assign the cross-licenses to a subsidiary of a direct competitor to Institut Pasteur ("Pasteur").[218] Not surprisingly, Pasteur objected to licensing its technology to a direct competitor.[219] The First Circuit upheld the bankruptcy court's decision to allow the assumption of the cross-licenses and the determination that the proposed sale was

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209 87 B.R. 943 (Bankr. N.D. Ill. 1988).
210 *Id.* at 948.
211 *Id.* at 945.
212 *Id.* at 948.
213 *Id.*; Elaine D. Ziff, *The Effect of Corporate Acquisitions on the Target Company's License Rights*, 57 BUS. LAW. 767 (2002).
214 *Id.*
215 104 F.3d 489 (1st Cir. 1997).
216 *Id.* at 490.
217 *Id.*
218 *Id.*
219 *Id.*

not actually an assignment, but merely an assumption by the reorganized debtor under new ownership.[220] Although a patent license, the court found that the relationship between the two parties was not a personal services contract.[221] However, since the First Circuit adopts the actual test, if the use by the new owners is not an assignment, the licensee will be allowed to assume a contract it does not intend to assign even if the applicable law would not ordinarily permit the assignment.[222] Therefore, the First Circuit did not need to decide whether the license was a personal services contract or not. The result of the decision, though, effectively required Pasteur to license its patented technology to a competitor.

Some courts, however, take into consideration the commercial interests of the licensor when deciding whether to allow an assignment by a debtor-licensee.[223] The bankruptcy court in *In re Access Beyond Techs., Inc.*[224] allowed a patent licensor to prohibit assignment by the debtor-licensee to a direct competitor that would eliminate any competitive advantage by the licensor in the market.[225] First, the court determined that the license was executory because each party had a continuing obligation to refrain from suing the other for infringement and each party was required to grant the other party sub-licenses.[226] Noting that the patent laws are designed to prevent a direct competitor from using a patented invention without permission of the patent owner, the court found that the patent license was a personal services contract and not assignable notwithstanding the provision allowing sublicensing.[227]

Although there are few cases deciding the issue of whether software licenses are personal services contracts and thus unassignable by a debtor-licensee, two such cases find that

[220] *Id.* at 491.
[221] *Id.*
[222] *See id.* at 494.
[223] *See* Ziff, *supra* note 213, at 767.
[224] 237 B.R. 32 (Bankr. D. Del. 1999).
[225] *Id.* at 45.
[226] *Id.* at 43–44.
[227] *Id.* at 45.

software licenses are unassignable under applicable law.[228] The court in *Buildnet* found that under the Copyright Act, nonexclusive software licenses are personal to the licensees and therefore not assignable without the consent of the licensor.[229] In addition, since the software at issue was "highly sophisticated and customized for the individual needs of a customer," the needs of the customer were reflected in the purchase price making the identity of the licensee material.[230] Since the license also contained a confidentiality provision, the possibility of purchase by a competitor would "strip the copyright holder of the right to control the dissemination of their copyrighted material and would undermine the purpose of the Copyright Act."[231]

V. DRAFTING A SOFTWARE LICENSE TO PROTECT YOUR CLIENT IN THE EVENT OF A BANKRUPTCY

This part provides some ideas of possible fixes to the problems listed in the rest of this Article. While by no means an exhaustive list of tips for negotiating or drafting a software licensing agreement, it does provide some idea of how a party can protect its rights in anticipation of a future bankruptcy filing by one of the parties to the agreement.

A. Congressional Fixes

Much of the confusion inherent in software licenses in bankruptcy arises due to the ambiguity in the Bankruptcy Code when reading § 365(c)(1) and § 365(f) together.[232] One way to make the results of a bankruptcy petition on a software license more predictable would be to actually fix the statute.[233] Either section could be amended to make the two provisions consistent. One proposed change would amend § 365(c)(1) to read "the

[228] RCI Tech. Corp. v. Sunterra Corp. (*In re* Sunterra Corp.), 361 F.3d 257, 260 (4th Cir. 2004); *In re* BulidNet, Inc., 2002 Bankr. LEXIS 1851 (Bankr. M.D.N.C. 2002).
[229] *In re* BuildNet, Inc., 2002 Bankr. LEXIS 1851, at *13.
[230] *Id.* at *16.
[231] *Id.*
[232] *See supra* Part III.
[233] *See* Louie, *supra* note 189, at 362.

[debtor] may not assume *and* assign any executory contract."[234] This would make it clear that the actual test is preferred and would allow a debtor to assume a license even if applicable law prohibited an assignment.[235]

In addition to resolving the split between the actual and hypothetical tests, a comprehensive congressional fix should resolve the question of whether nonexclusive intellectual property licenses are personal services contracts.[236] Although most courts do find nonexclusive patent and copyright licenses to be personal services contracts, the lack of statutory guidance makes this outcome somewhat unpredictable. Finally, a statutory definition of executory contracts with specific language regarding what obligations are sufficient to constitute a finding of an executory contract would clear up considerable unpredictability and ambiguity that plagues software licenses when one party files for bankruptcy.[237]

B. Carefully Structure Licensing Agreements Prior to Bankruptcy

Since any type of statutory amendment would require much time and lobbying in order to become reality, it is not a practical solution for parties currently engaged in licensing software. For those parties unable to wait for a statutory or judicially created fix to the problems mentioned in this article, one solution is to carefully structure the software license in an attempt to gain at least some control over the outcome in the event one party to the agreement files for bankruptcy.[238]

As mentioned above, simply including a clause triggering termination of the license upon a bankruptcy filing will not work because such provisions have no effect in bankruptcy.[239] Instead, the parties can structure the transaction as something other than a license.[240] Since a contract can escape executory treatment in

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[234] *Id*. at 367 (emphasis added).
[235] *Id.*
[236] *See* discussion *supra* Part IV.
[237] *See* discussion *supra* Part IV.
[238] Louie, *supra* note 189, at 362.
[239] *See* discussion *supra* Part IV.
[240] Louie, *supra* note 189, at 362.

bankruptcy if one or both parties have fully performed, one way to contract around the problems listed in this Article is to create a fully paid, nonexecutory license for the software and put any continuing obligations, like maintenance and upgrade services in a separate executory contract.[241] In the event of a bankruptcy filing, only the executory agreement would be subject to § 365.[242] This option will be more attractive to the licensee since a completed transfer will result in copyright rights being swept into the bankruptcy estate, available to the licensee's trustee for use, sale or lease.[243] It is unclear whether § 363 provides any protection for the licensor should this situation occur.[244]

A contract can also escape executory treatment if it is terminated by one party in reaction to the other party's material breach prior to the bankruptcy filing.[245] This option is more attractive to the licensor than the previously mentioned "completed transfer" option.[246] In order to allow for this prebankruptcy termination, a software license should include a provision allowing for termination at will by either party or termination based on a specified failure.[247] Examples of such failures are nonpayment of fees or failure of one party to meet objective performance criteria.[248] Termination clauses that include a cure right or grace period are risky because if the other party files for bankruptcy during a contractual grace period, the right to cure will pass to the trustee.[249] A licensor will benefit from an automatic reversion clause, which will provide for reversion of all formally licensed or assigned rights upon termination.[250] This will ensure that a licensee does not retain any use rights no matter which view of rejection the court embraces when dealing with nonexclusive licenses.[251] Finally, the party who terminates a license agreement

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241 *Id.* at 363.
242 *See id.* at 362.
243 BRINSON, *supra* note 15, at 544–45.
244 *Id.*
245 *Id.* at 543.
246 *See id.* at 543–44.
247 *See id.* at 543.
248 *Id.* at 542.
249 *Id.* at 544–45.
250 *Id.* at 545–46.
251 *See* discussion *supra* Part II.C.

should obtain written acknowledgment, if possible, from the other party to eliminate any doubt as to the status of the contract in the event of a bankruptcy filing.

C. Carefully Designate Payments

Under § 365(n), the licensee, to retain its rights to a rejected license, must continue to pay royalties.[252] Therefore, it is important when negotiating the license to clearly define the royalty payments. Moreover, if other payments are due, it is important to specify what those payments are in consideration for, such as a maintenance or upgrade fee; "that way there is less of a risk that a bankruptcy court will subsequently recharacterize such payments as [continuing] royalties."[253] In order "to provide additional incentive to the licensor to assume the license in a subsequent bankruptcy, the licensee could try to structure the royalty payments and other license payments to be distributed evenly over the term of the license rather than a 'front-end-loaded' license."[254]

D. Source Code Escrow

Software licenses often have included provisions or an entire supplementary agreement providing for source code escrow.[255] The licensor will be required to deposit the source code into a third party escrow if certain trigger events occur.[256] As mentioned several times in this article, while it is common for the trigger event to be insolvency or a bankruptcy filing, these provisions will not be honored in bankruptcy.[257] Even if the trigger is valid within bankruptcy, it is probable that the reorganized debtor or trustee will not have the knowledge or resources to assist in the transfer of

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252 11 U.S.C. § 365(n)(2)(B) (2000).
253 Philip S. Warden, *Protecting Your Rights to Intellectual Property in Bankruptcy*, PILLSBURY, WINTHROP, SHAW, PITTMAN, Dec. 1, 1999, *available at* http://library.findlaw.com/1999/Sep/1/129756.html (citing Warden and Costello, *New Bankruptcy Code § 365(n): Limited Comfort for the Technology Licensee*, 10 CEB CAL. BUS. L. REP. 158 (1989)).
254 *Id*.
255 Denson, *supra* note 49, at 2.
256 *Id.*
257 *See* discussion *supra* Part I.

the software to the non-debtor.[258] Therefore, in order for software turned over to the licensee to be useful, it needs to be the most recent version and sufficiently detailed for the licensee to use and understand without the help of the licensor.[259]

In order to make a software escrow agreement worthwhile, the trigger for a source code turnover should be based on something other than the financial situation or bankruptcy filing of the licensor.[260] For instance, the license can include a clause that gives the licensee the right to decide when an event triggering release has occurred, if possible, without the required approval from the licensor.[261] Any trigger should be clearly spelled out to avoid disagreement over whether a release has actually occurred.[262]

In addition, the agreement should specify as explicitly as possible the version of the software to be turned over.[263] The licensor should have an affirmative duty under the agreement to update and document any source code in escrow.[264] This can be guaranteed by providing in the agreement for the use of a reputable, proven escrow agent with an adequate verification process in place.[265] This verification process gives assurances to the licensee that the source code is being well-maintained and will be usable, without licensor support, upon release.[266] Finally, the license should provide that the licensee can hire the licensor's employees who are knowledgeable about the software if the licensor is no longer willing or able to provide assistance under the license.[267]

258 *See* Denson, *supra* note 49, at 3–4.
259 Warden, *supra* note 253.
260 *See* discussion *supra* Part V.C.
261 Denson, *supra* note 53, at 15–16.
262 *Id*.
263 Warden, *supra* note 253.
264 *Id*.
265 Denson, *supra* note 53, at 16.
266 *Id*.
267 Warden, *supra* note 253.

E. Object Early and Often in Debtor's Attempt to Sell Property Free and Clear

In order to prevent a *Qualitech*-type loss of licensee interest in a technology license, a licensee of any licensor that files for bankruptcy should object early and often to any motion for a free and clear sale of the debtor's actions and/or insist on adequate protection from any such sale.[268] In addition, any software licensee should be alert for any notice following a bankruptcy filing by the licensor of any of its critical software.[269]

F. Special Purpose Vehicles

A more complicated, but potentially quite powerful, technique for avoiding bankruptcy-related problems is to create a bankruptcy remote entity and transfer title to the software to this entity.[270] A bankruptcy remote entity is an entity that is ineligible for bankruptcy and serves a special purpose, such as holding intellectual property, with less bankruptcy risk.[271] In order to carry out this technique, the license can establish a trust which is not eligible for bankruptcy.[272] The trust then should create beneficial interests and licenses in favor of both parties.[273] The parties can, instead, create a LLC in which they are both members.[274] Finally, the licensor can contribute the software to a special holding subsidiary, which does not have any debt or creditors and therefore can predictably remain solvent.[275] In order to protect the licensee's interests completely, the parties should follow steps to make sure

268 *See* Zinman, *supra* note 120, at 160–61.

269 *See id.* at 120. Professor Alec Ostrow believes one of the problems leading to the *Qualitech* decision was that Qualitech was given inadequate notice of the sale and did not realize that its rights as a lessee were in jeopardy. *Id.* at 120 n.75.

270 Louie, *supra* note 189, at 364.

271 *Id.*

272 G. Larry Engel & Menachem O. Zelmanovitz, *Failing Biotechnology Companies: Fire Sales and Bankruptcy: Risks and Opportunities in Acquiring Biotechnology Enterprises*, 760 PLI/Pat, 879–80 (2003).

273 *Id.*

274 *Id.*

275 *Id.*

that the special purpose entity remains separate from the licensor.[276]

G. Create a Security Interest

Finally, either party can take a security interest in the license.[277] The foreclosure on the security interest can occur prior to bankruptcy if valid triggers are included in the contract.[278] If the foreclosure is completed before the other party enters bankruptcy, the court will not reverse the foreclosure.[279] In addition, bankruptcy law respects the rights of secured creditors giving them protections unavailable to unsecured creditors.[280] Section 363 requires a trustee to "prohibit [the] . . . use, sale, or lease as is necessary to provide adequate protection" of property on request of the secured party.[281]

VI. CONCLUSION

Software licenses are generally liable to sometimes surprising treatment when one party files for bankruptcy.[282] This treatment can be devastating to a business that relies on the software involved, either as a primary asset or as a tool on which their business is run.[283] Since the amendment of the bankruptcy code is unlikely in the short-term, parties to a software license should anticipate the bankruptcy possibilities and draft their licenses accordingly.[284]

Software licenses will likely be treated as executory contracts in bankruptcy.[285] Since the options given to the debtor when a contract is found to be executory, rejection, assumption, and assignment, may be undesirable from the perspective of the non-

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276 *See id.*

277 *See* Louie, *supra* note 189, at 351; Brinson, *supra* note 15, at 541–42.

278 Brinson, *supra* note 15, at 541–42.

279 *Id.*

280 Brinson, *supra* note 15, at 541–42. *See also* 11 U.S.C. § 725.

281 11 U.S.C.A. § 363(e) (2006).

282 *See* discussion *supra* Part I.D.

283 *See* discussion *supra* Introduction.

284 *See* discussion *supra* Part V.B.

285 *See* discussion *supra* Part I.D-E.

bankruptcy party, parties drafting software licenses may wish to attempt to draft their agreements in a way to avoid executory treatment.[286] In addition, parties can use various other techniques to ensure that their rights are protected in the event of the bankruptcy filing by the other party to the agreement.[287]

[286] *See* discussion *supra* Part V.B-C.
[287] *See* discussion *supra* Part V.D–F.