

**RECENT DEVELOPMENTS AFFECTING LICENSEES OF SOFTWARE
IN BANKRUPTCY CASES**

Two recent Circuit Court decisions, *RCI Technology Corp. v. Sunterra Corp. (In re Sunterra Corp.)* and *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC*, adversely impact the rights of licensees of software and other intellectual property when a bankruptcy intervenes. This client advisory discusses the holdings of these cases, and some strategies that affected parties should consider.

***RCI TECHNOLOGY CORP. V. SUNTERRA CORP.
(IN RE SUNTERRA CORP.)******Introduction***

An important decision of the Fourth Circuit Court of Appeals, *RCI Technology Corp. v. Sunterra Corp. (In re Sunterra Corp.)*,¹ demonstrates how a bankruptcy filing by a company can adversely affect that company's rights as a licensee of software. This is an important issue for any licensee of software contemplating the need for a Chapter 11 reorganization or any software licensor that has a customer that files bankruptcy. This is also important for any company that does business with another company that may someday file bankruptcy, particularly in the outsourcing area.

The Facts of the Sunterra Corp. Case

Sunterra, a large resort management business, needed an integrated computer system to manage the timeshare ownership program at its resorts. In 1991, Sunterra paid RCI a one time fee of \$3.5 million for a "non-exclusive, worldwide, perpetual, irrevocable, royalty-free license . . . to use, modify and distribute" certain software of RCI (the "Software").² Under the license agreement (the "Agreement"), Sunterra was authorized to use the Software to develop its own software system. Sunterra invested approximately \$38 million to develop its own system based on the Software.

Nine years later, Sunterra filed a Chapter 11 bankruptcy petition, and two years after that, Sunterra's plan of reorganization was confirmed. Prior to confirmation of the plan,

¹ 361 F.3d 257 (4th Cir. 2004).

² *Id.* at 260.

however, RCI filed a motion to deem the Agreement rejected, asserting that Sunterra could not assume the Agreement without RCI's consent (which RCI refused to give). RCI lost at the bankruptcy court and on appeal to the district court, but on appeal to the Fourth Circuit, RCI won. As explained below, the Fourth Circuit concluded that, because of the interaction of bankruptcy law and copyright law, Sunterra was precluded from assuming the Agreement.

The decision allows RCI to charge Sunterra a new royalty fee as a condition to a new, post-bankruptcy license, even though 11 years before, after payment of a one time fee, Sunterra – and RCI – thought Sunterra had a perpetual, royalty free license.

Assumption and Assignment of Executory Contracts in Bankruptcy

Most lawyers and many business people understand that the Bankruptcy Code has some special rules about the assumption and assignment of executory agreements and unexpired leases. The basic rules give a debtor *more* power than the contract counterparty. For example, the debtor can reject executory contracts or unexpired leases that it finds disadvantageous,³ and the counterparty's damages are considered pre-petition claims⁴ – claims that are usually paid little or nothing in a bankruptcy case. By contrast, provisions in executory contracts that permit the non-debtor party to terminate upon the debtor's bankruptcy are usually unenforceable.⁵ The debtor usually can wait until confirmation of a plan before deciding whether or not to assume an agreement.⁶ Even when the debtor is in default, if a debtor cures those defaults (or gives adequate assurance of prompt cure) then the debtor can assume the executory contract or unexpired lease.⁷ Furthermore, as a general rule, a debtor can assign an assumed agreement to a third party, even if the agreement prohibits assignments.⁸ Once the agreement is assigned, the debtor is no longer obligated on the agreement.⁹

With all these provisions favoring a debtor, what happened in *Sunterra Corp.*? The court's decision turns on the use of the word "or" (rather than the word "and") in Bank-

³ Bankruptcy Code § 365(a).

⁴ Bankruptcy Code § 365(g).

⁵ Bankruptcy Code § 365(e)(1).

⁶ Bankruptcy Code § 365(d)(2).

⁷ Bankruptcy Code § 365(b)(1).

⁸ Bankruptcy Code § 365(f)(2) and (f)(3).

⁹ Bankruptcy Code § 365(k).

ruptcy Code § 365(c). That subsection creates an exception to the usual power to assume or assign an executory contract. It states:

The trustee¹⁰ may not assume **or** assign any executory contract . . . , if – (1)(A) applicable law excuses [the non-debtor] party . . . to such contract . . . from accepting performance from or rendering performance to an entity other than the debtor or debtor in possession. . . ; and (B) such party does not consent to such assumption **or** assignment. . . .

(emphasis added). In this case, copyright law was the applicable law that excused RCI from accepting performance from, or rendering performance to, a party other than Sunterra. A non-exclusive license to a copyright cannot be *assigned* by the licensee without the consent of the licensor.¹¹ In *Sunterra Corp.*, however, the Court’s literal reading of Section 365(c) of the Bankruptcy Code meant not only that Sunterra could not *assign* the license, but that Sunterra could not *assume* the license—thus, Sunterra’s fully paid, royalty free, perpetual license was extinguished as a result of Sunterra’s bankruptcy filing.¹²

Sunterra argued that this literal reading of Section 365(c) leads to a result that is absurd, but the Fourth Circuit disagreed. Significantly, the Fourth Circuit is not alone – the same result has been reached by several other Circuits and several bankruptcy courts.¹³ Other courts, such as the First Circuit, have refused to apply § 365(c) to prohibit a debtor from *assuming* such an executory contract, even though it would prohibit an *assignment*.¹⁴

Ramifications of the Sunterra Corp. Decision

This client advisory will not debate whether or not the Fourth Circuit’s decision is correct. Unless and until the split in the Circuits is resolved one way or the other, the holding in

¹⁰ A debtor in possession has most of the powers and duties of a trustee. Bankruptcy Code § 1107.

¹¹ 361 F.3d at 262 n.7.

¹² Sunterra also argued that the license was not an executory contract. However, the court noted that both parties had an ongoing obligation to maintain the confidentiality of the source code, which was sufficient for the Fourth Circuit to conclude that the Agreement was “executory” within the meaning of the Bankruptcy Code. 361 F.3d at 264.

¹³ See, e.g., *Perlman v. Catapult Entm’t (In re Catapult Entm’t, Inc.)*, 165 F.3d 747, 750 (9th Cir. 1999) (patent licenses could not be assumed); *Rieser v. Dayton Country Club Co. (In re Magness)*, 972 F.2d 689, 695 (6th Cir. 1992)(golfing memberships in a private club); *In re West Elecs., Inc.*, 852 F.2d 79, 83 (3d Cir. 1988) (government procurement contract). See also *City of Jamestown, Tenn. v. James Cable Partners, L.P. (In re James Cable Partners)*, 27 F.3d 534, 537 (11th Cir. 1994) (cable franchise; assignment not permitted by city ordinance, but court held city did not show that applicable law renders performance non-delegable.).

¹⁴ *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489, 493 (1st Cir. 1997) (patent license). The majority of bankruptcy courts also apply the so-called “actual” test. *Sunterra Corp.*, 361 F.3d at 262.

Sunterra Corp. presents some unique challenges and opportunities in several areas of practice.

First, any company that is considering bankruptcy and hopes to emerge as a reorganized debtor¹⁵ has another level of due diligence: to what extent does it depend on software licenses where the licensor's consent to assumption under § 365 will be required? In addition to the "normal" problems a debtor faces - operational problems, excessive debt load, wages and benefits that are higher than industry averages because of collective bargaining agreements - the potential debtor may now have another economic burden – paying for new software licenses. By contrast, software licensors have a potential new source of revenue – from what might otherwise be a most unlikely source.

Second, the problem highlighted by *Sunterra Corp.* can extend to another step. For instance, in outsourcing contracts, the customer relies on a vendor to perform many critical functions. Often, the functions performed by the vendor will be highly automated and software driven. The software solutions offered by the vendor may, in turn, be dependent on software licenses from third parties. If the vendor files bankruptcy, in addition to all of the other problems that this presents for the customer,¹⁶ will the vendor's ability to perform post-confirmation be dependent on its ability to arrange new, post-bankruptcy licenses?

Potential Ways to Mitigate the Sunterra Corp. Risks

Parties may be able to avoid the results of *Sunterra Corp.* by drafting around it. *Sunterra* argued that it already had: the Agreement provided that "The provisions of this section shall not preclude the transfer of this license to a successor in interest of substantially all of [Sunterra's] assets if the assignee agrees in writing to be bound by this License." However, the Fourth Circuit decided that this language only applied to assignments, and not an assumption of the license by *Sunterra*. It would seem, therefore, that the Fourth Circuit would require the licensor to consent, in the license agreement, to the licensee's assumption of the license under Section 365. The Fourth Circuit recognized that another court had found such an explicit consent was sufficient to avoid the impact of a literal reading of Section 365.¹⁷

Thus, software licensees (and any parties to any other contract where, under applicable law, the counterparty to the agreement is not required to accept performance from, or

¹⁵ Many companies file Chapter 11 cases in order to effect a sale free and clear of liens using § 363 of the Bankruptcy Code. In such sales it is almost always true that the debtor also assumes and assigns executory contracts and unexpired leases to the purchaser, using § 365. In such a case, it doesn't matter if § 365 uses the word "or" or the word "and" – the executory contracts are being assigned. Therefore, non-exclusive software licenses cannot be assigned without the consent of the licensor. The need to obtain such consent must be taken into account as part of the bankruptcy planning.

¹⁶ See John C. Weitnauer, *Outsourcing Contracts, Licenses, and Bankruptcy Law*, 9 Ga. Bar J. 10 (2003).

¹⁷ *Metro. Airports Comm'n v. Northwest Airlines, Inc. (In re Midway Airlines)*, 6 F.3d 492 (7th Cir. 1993).

render performance to, an assignee) should add to their license an explicit provision in which the licensor consents to the licensee's assumption of the license in bankruptcy. Companies that have outsourced their critical functions to third parties should consider requiring proof that, should the vendor file bankruptcy, the vendor will be able to assume any underlying licenses upon which the vendor's services to the customer depends.

PRECISION INDUSTRIES, INC. V. QUALITECH STEEL SBQ, LLC

The Seventh Circuit's decision in *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC*¹⁸ involved a real estate lease, rather than a license, but its holding may apply to licenses. As noted above, a debtor in possession¹⁹ can reject an executory contract or an unexpired lease.²⁰ In some cases, the counter-party is given certain protections against the impact of the rejection. For example, Section 365(h) permits a tenant to remain in possession of the premises for the term, although the debtor landlord is not required to perform other obligations under the rejected lease.²¹ Similarly, Section 365(n) permits a licensee of intellectual property to enforce the license for its term but must continue to pay royalties.²²

The novelty of *Precision Industries* is its holding that a debtor in possession can use another section of the Bankruptcy Code, Section 363(f) – which authorizes sales of property free and clear – to trump the protections given to a lessee by Section 365(h). The same reasoning would mean that Section 363(f) can trump the protections given a licensee by Section 365(n).

The Facts of the Precision Industries Case

Prior to bankruptcy, Qualitech entered into a 10 year, \$1/year lease with Precision, pursuant to which Precision constructed a warehouse for the purpose of providing dedicated supply services to Qualitech's steel mill.²³ A year later, Qualitech filed bankruptcy, and several months after the filing, sold the real estate subject to the lease "free and clear of all liens, claims, encumbrances, and interests" pursuant to Section 363(f) of the Bankruptcy Code.²⁴ The sale order reserved for the purchaser the debtor's right to assume and assign executory contracts. The sale closed without an assumption and assignment of the lease with Precision, and the new buyer and Precision negotiated

¹⁸ 327 F.3d 537 (7th Cir. 2003).

¹⁹ A debtor in possession has most of the powers and duties of a trustee. Bankruptcy Code § 1107.

²⁰ Bankruptcy Code § 365(a).

²¹ Bankruptcy Code § 365(h)(1)(B).

²² Bankruptcy Code § 365(n).

²³ There were two debtors and two related agreements with Precision (and a company related to Precision), but for convenience, they are referred to here in the singular. 327 F.3d at 540.

²⁴ Qualitech sold substantially all of its other assets at the same time. *Id.*

for some time regarding same. Ultimately, however, negotiations broke down, and Precision vacated the warehouse and padlocked it.²⁵ The buyer changed the locks, and Precision brought suit, claimed that its leasehold interest survived the sale. The Circuit Court disagreed.²⁶

The Seventh Circuit put the issue this way: does a sale under Section 363(f) “free and clear of all interests” operate to extinguish a lessee’s possessory interest in the property, or does Section 365(h) preserve that interest?²⁷ For a variety of reasons, the Court concluded that Section 365(h) does not preserve that interest.

Impact on Licensees

How might the holding of Precision Industries impact licensees? A good example is a case intellectual property lawyers will remember -- *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.)*.²⁸ In that case, Richmond Metal Finishers (“RMF”) granted Lubrizol a nonexclusive license to use a metal coating process. RMF sought to reject the agreement with Lubrizol because RMF would be able to sell or license the technology to other firms on more advantageous terms if Lubrizol no longer had rights to the process. The Circuit Court found that the agreement was executory, that the debtor had met the “business judgment” standard to justify rejection, and most importantly, that money damages were Lubrizol’s only remedy – *it could not retain its contract rights in the technology by specific performance*, even though that remedy would ordinarily be available upon breach of such an agreement.²⁹ (It is important to remember that the money damages allowed are, by statute, considered pre-petition unsecured claims, which are typically paid little or nothing in a bankruptcy case.) The outcry following the *Lubrizol Enterprises* decision spurred Congress to enact Section 365(n), which overruled *Lubrizol Enterprises* for licensees of intellectual property.³⁰ However, if Section 363(f) can trump Section 365(h) (as *Precision Industries* held), another court may find that Section 363 (f) can trump Section 365(n), and that *Lubrizol Enterprises* may have been resurrected.

²⁵ *Id.* at 541.

²⁶ *Id.* at 540.

²⁷ *Id.* at 543.

²⁸ 756 F.2d 1043 (4th Cir. 1985), cert. denied sub. nom. *Lubrizol Ent., Inc. v. Canfield*, 475 U.S. 1057 (1986).

²⁹ 756 F.2d at 1048.

³⁰ “Intellectual property” is defined for this purpose as “(A) trade secret; (B) invention, process, design, or plant protected by title 35; (C) patent application; (D) plant variety; (E) work of authorship protected under title 17; or (F) mask work protected under chapter 9 of title 17; to the extent protected by applicable nonbankruptcy law.” Bankruptcy Code § 101(35A).

The Court's reasoning in *Precision Industries*, and its failure to take into account other provisions of the Bankruptcy Code, has been subjected to harsh criticism,³¹ but unless the law in a Circuit in which a case is pending is decided to the contrary, parties to the case need to take actions based on the possibility that *Precision Industries* is, or will be found to be, the law. While there are certainly bankruptcy cases that result in a reorganized debtor emerging from bankruptcy, it is more and more common for bankruptcy to be used for the power of Section 363 to effect a prompt, "clean" sale of assets, freed from the debtor's liabilities of nearly every sort. *Precision Industries* provides another incentive, in the right case, for a debtor to use this "expanded" power of Section 363(f).

What can a lessee or licensee do? There is no certain answer, but at a minimum, lessees of real property and licensees of intellectual property should object to any motion to sell the underlying property "free and clear," even if there is no mention of the lease or license. That will position the lessee or licensee to invoke – *before the sale* – Section 363(e), which provides that on request of an entity that has "an interest in property . . . sold, or . . . proposed to be . . . sold . . . the court . . . shall prohibit or condition such sale . . . as is necessary to provide adequate protection of such interest." When adequate protection is required, it can be provided by requiring the debtor in possession "to make a cash payment . . . to the extent that the . . . sale under section 363 . . . results in a decrease in the value of such entities' interest in such property; . . . or granting such other relief . . . as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property."³²

CONCLUSION

Both *Sunterra Corp.* and *Precision Industries* show how, when bankruptcy law and the law relating to licenses interact, unexpected results can occur. More than ever, a licensee needs to carefully evaluate the impact of a bankruptcy case – whether its own case or a case filed by its licensor – on its rights.

³¹ See, e.g., Michael St. Patrick Baxster, *Section 363 Sales Free and Clear of Interests: Why the Seventh Circuit Erred in Precision Industries v. Qualitech Steel*, 59 Bus. Law. 475 (2004).

³² Bankruptcy Code § 361. Another reason to object before a sale is that, upon a closing of the sale, an appeal is rendered moot. See Bankruptcy Code § 363(m).

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