

# Bankruptcy & Insolvency Issues in Technology Agreements: The Top 5 Pitfalls

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## Introduction

- in today's unsettled markets, technology practitioners need to focus on how best to structure technology arrangements to contemplate the risk of the bankruptcy/insolvency of one of the parties
- specific effects of bankruptcy/insolvency event will depend on:
  - the nature of the event (e.g. in Canada, whether the party is subject to bankruptcy proposal or a CCAA plan)
  - the jurisdiction of the party
- however, the key challenge in practice is that such an event will often render moot the carefully crafted language of the technology agmt
- to address this risk, there therefore needs to be a greater focus on governance issues, rather than the provisions of the contract
- this seminar **will focus on the case where the technology provider goes bankrupt**, due to the operational complexities it raises for the customer

# Introduction

- Part I: **A Bankruptcy Primer**
  - Canada: Bankruptcy Act & the Companies Creditors Agreement Act
  - US: Chapters 11 and 7 of the Bankruptcy Code
  - “Sword” trustee rights, & the role of the “stay” as “Shield”
- Part II: **Top 5 Bankruptcy Pitfalls in a Technology Agreement**
  1. Avoiding the Stay: Early Warning Systems
  2. Avoiding the Disclaimer: Transition Services
  3. Avoiding the Disclaimer: IP Licence Carve-Out
  4. Avoiding Overreliance on Escrow Agreements
  5. Employee Issues

# Part I: A Bankruptcy Primer



## A. Introduction

- Effectively, the risks are caused by two categories of rights which are made available in the event of a bankruptcy:
  1. **“Sword” rights**: wherein the trustee is granted certain rights in connection with the technology agmt – specifically, the rights to **assume, disclaim or assign** the agmt
  2. **“Shield” rights**: wherein certain rights that customer may have under the agmt are **“stayed”** (incl. **“ipso facto” rights**: i.e. rights triggered by the bankruptcy/insolvency event itself).

## B. Brief overview of Canadian regime

- Regime is in flux: amendments were expected to come into force in 2008 but are still pending...
- Two major vehicles:
  - *Bankruptcy and Insolvency Act*
  - *Companies Creditors Agreement Act*
- 1. *Bankruptcy and Insolvency Act (“BIA”)*
  - Seeks to:
    - maximize the value of the estate for the benefit of creditors, in the case where liquidation of assets
    - to maintain the *status quo* while the debtor reorganizes or the estate’s administrator analyses the value of the estate’s assets
  - Uses “proposals”: an agmt between debtor & creditors re restructuring, which receives court approval
  - Less flexible than CCAA, more akin to Chapter 11 in the US

## B. Brief overview of Canadian regime

### 2. *Companies Creditors Agreement Act (“CCAA”)*

- Focus is more on continuing to operate the debtor as an ongoing concern
- Uses “plans”: i.e. formal plan of arrangement similar to BIA “proposal”
- Restricted to co.’s with \$5 mil+ owing to creditors
- Generally a more flexible mechanism; short piece of legislation, with therefore more focus on the role of the court & on negotiation between the applicable stakeholders

- **US Bankruptcy Regime**

#### 1. *Chapter 11 of US Bankruptcy Code*

- Formalized process which provides for reorganization of debtor

#### 2. *Chapter 7 of US Bankruptcy Code*

- More generally address bankruptcy outside of reorganization context

## C. “Sword” rights for the trustee

### 1. Right to Disclaim Agmt

- BIA
  - As amended, expressly permits debtor to disclaim certain agmts (incl. technology agmt)
    - requires trustee approval, or court approval
  - BUT counterparty customer:
    - May apply to court to disallow the disclaimer
    - If disclaimed, will have a provable claim for losses suffered, which can be tendered into the bankruptcy
- **CCAA** = as amended, very similar to BIA
- **Chapter 11 US Bankruptcy Code**
  - Debtor can “reject” a contract, but like in Canada, rejection under a reorganization = a breach, for which damages can be claimed
  - No cherry-picking permitted
  - Court approval required

## C. “Sword” rights for the trustee

### 2. Right to Assign Agmt

- BIA
  - As amended, permits trustee to apply for court order to assign
  - Courts will approve such assignment where conditions met, incl:
    - Assignee is able to perform assigned obligations
    - = possible customer anti-assignment mechanism of incl. req'mts in technology agmt which are very specific to that provider (e.g. key personnel clauses, where personnel are named)
    - Assignment is “appropriate”
    - All “monetary” defaults are cured at time of assignment
- **CCAA** = again, as amended, very similar to BIA
- **Chapter 11 US Bankruptcy Code**
  - Overrides anti-assignment clauses so as to permit assignment
  - BUT must be adequate assurance of assignee future performance & assignment is not permitted if not possible under ordinary law (e.g. contract for personal services)

## D. “Shield” rights: The role of the “stay”

- Customer has certain remedies available where provider is insolvent, but not yet bankrupt
  - E.g. can terminate for (a) material breach, in which case any claim for damages will be another (generally) unsecured claim against the estate of the debtor service provider or (b) based on the fact of the debtor’s insolvency
- BUT upon the initiation of a BIA proposal or a CCAA plan = a “**stay**” is created which limits certain customer remedies
- **BIA:** Customer counterparty to agmt:
  - cannot rely on **pre-filing defaults in payment** (can rely on other defaults – e.g. re performance)
  - cannot rely on ***ipso facto* clauses to terminate** the contract
  - can invoke other types of pre-filing breaches by the debtor, if they are sufficiently fundamental, to terminate (e.g. re performance)
- **CCAA:** unlike BIA, cannot rely on **any defaults, even re performance**
- **Chapter 11 US Bankruptcy Code:** all ***ipso facto* termination rights** are stayed

Part II:  
Top 5 Bankruptcy Pitfalls  
in a Technology Agreement



## 1. Avoiding the Stay: Early Warning Systems

- Draft definition of “insolvency event” in technology agmt so broader than formal bankruptcy; if it is, parts of insolvency event termination trigger will not be stayed as not *ipso facto* clauses
  - provider/provider’s applicable dept ceases to carry on business in ordinary course
  - if Moody’s Investors Service, Standard & Poors or Dun & Bradstreet lower the credit rating of the Provider from the rating as of the Effective Date by more than two (2) steps...
  - ... or Customer otherwise has reasonable cause to doubt Provider’s financial stability (including concerns over Provider’s ability to perform its obligations under any Service Schedule consistently and in a sustained manner)
- BUT difficult to draft exhaustively all potential warning signs of a pending insolvency + in such a way that provider can agree to same

# 1. Avoiding the Stay: Early Warning Systems

- Therefore look past the formal *ipso facto* clauses, & focus on implementing early warning governance mechanisms so customer can “beat the stay”.
- In addition to customer reviewing provider financial statements prior to engagement, customer should commit provider to provide:
  - a certain level of **periodic financial reporting**
  - a **rep & warranty** that such reports fairly/accurately represent financial condition/results of operations of provider as of reporting dates/periods, & there has not since been a material adverse change
  - again on such a periodic basis, an **officer’s certificate** certifying that there has been no such material adverse change
  - such certificate **in person**, in a meeting with appropriate customer personnel = forces both parties to focus on importance

## 2. Avoiding the Disclaimer: Transition Services

- customer position that, where it is seeking to terminate agreement based on material breach/insolvency of provider, should not need to pay for information transfer/consulting-type transition services (so customer can begin to mitigate its damages)
- BUT if successful, customer may have effectively won the battle but lost the war
- trustee is more likely to disclaim an agreement where there is an expenditure of resources but no compensatory revenue
- issue is equally applicable to any other aspect of agmt where the customer successfully bargained to receive certain services at no cost

### 3. Avoiding the Disclaimer: IP Licence Carve-Out

- IP licenses will be carved out from trustee disclaimer right
- Important where there is technology backbone to the technology
- **BIA/CCAA:** issue as to whether software licence could be disclaimed was heavily debated; once amended, disclaimer of license by debtor will give licensee option of treating license as terminated OR continuing to use IP (including exclusive use if license is exclusive) for term & term extension, so long as performs its licence obligations (e.g. pay all applicable licence fees)
- **Chapter 11 of *US Bankruptcy Code*:** s.365(n) = same, but additional obligation on trustee to provide to licensee the “embodiment” of the IP (e.g. source code), to extent provided for in agmt/supplementary agmt (e.g. source code escrow agmt)

### 3. Avoiding the Disclaimer: IP Licence Carve-Out

- Two potential **pitfalls**:
  1. **Where not a pure licence agmt**: e.g. if outsourcing agmt, will be structured mainly as service agmt; a court may consider license to be *de minimis* to overall agreement and – correctly - characterize outsourcing agmt as not an intellectual property license = trustee could reject the technology agmt & licensee would have no protection.  
= licensee customer should separate the licence from technology agmt to try to ensure protection of license (+ for US provider, it should include an express reference in agmt that licence is an intellectual property license subject to §365(n))
  2. **Unbundling licence fees**: technology agmt should clearly separate all fees into their component parts (e.g. into licence fees, hosting fees, help desk fees, etc.), so customer can distinguish between licence fees, which the licensee must continue to pay, and fees for services that licensee no longer receives post-bankruptcy & for which it therefore may be relieved from paying

## 4. Avoiding over-reliance on Escrow Agmts

### 1. Enforceability

- **BIA:** yes.
- **CCAA:** not necessarily, if escrow release will hinder operation of debtor provider as going concern
- **Chapter 11 of US Bankruptcy Code:** case law suggests likely enforceable

### 2. Responsibility for **escrow fees**

### 3. Definition of **release triggers**: insolvency, plus more contentious =

- licensor ceases to provide maintenance / support for the software for more than X calendar days (or announces such intention)
- licensor ceases to do business in the ordinary course

### 4. Sufficiency of **deposit materials**: should include working notes, personnel contact info.

### 5. Danger of **two-party vs. three-party agreements**

## 5. Employee Matters

- need **non-solicitation carve-out**: allows customer to solicit/hire employees of provider where bankrupt
- need **confidentiality carve-out**: allows customer to use confidential information for above recruiting, & also to facilitate the transition-out to a designee of customer, if required, in each case where provider is bankrupt
- Again, however, given that these *ipso facto* carve-outs will be suspended by a stay, a customer can best ensure the enforceability of these carve-outs by including pre-stay triggers

Conclusion



- Timing is the most critical factor for a customer responding to a provider insolvency
- Once bankruptcy event has actually occurred, a number of customer remedies are now stayed, & trustee will have the ability to assign/disclaim the agmt
- Thus each customer should:
  - focus on implementing bankruptcy “early warning” governance and reporting mechanisms
  - in the case where there software licences underlying the technology arrangement, understand & plan for fact that escrow is not a “magic bullet”
  - plan in advance for the contingency, including through the implementation of a bankruptcy critical response plan
- As with many other contracting issues, the customer will best be able to mitigate the risk by investing the time now in planning a response.



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