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LUBRIZOL: WHAT WILL IT MEAN FOR THE SOFTWARE INDUSTRY?

James E. Meadows*

I. INTRODUCTION

Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc. has some serious overtones for vendors and vendees of computer software. The Lubrizol court permitted a bankrupt licensor of a metal coating process technology to reject its nonexclusive license to a licensee. Although the decision does not specifically mention computer software, its applicability to software is apparent in several situations. For example, the case could be extended to most OEM/VAR agreements because such agreements typically provide for continuing duties by both parties. The analysis could also be extended to sales of custom software products with continuing maintenance obligations on vendor and vendee license fees based on usage. If Lubrizol is construed to apply to the above situations, its greatest impact will be felt by small software vendors attempting to license software in the future and by current vendees who have based a significant portion of their businesses upon software li-

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2. A nonexclusive license is one which grants use permission to a licensee while not limiting the licensor's rights to license to future parties. The exclusive license binds the licensor not to enlarge the scope of other licenses already granted or increase the number of licenses.

3. 756 F.2d 1043, 1047 (4th Cir. 1985).

4. OEM stands for “Original Equipment Manufacturer,” and VAR stands for “Value Added Reseller.” An OEM/VAR agreement is where a software developer agrees that a software house or hardware manufacturer will distribute the developer's product in conjunction with other products (e.g., hardware, software or custom programming services) to be added by the distributor.

5. These continuing duties may include: development work or manufacturing responsibilities to be performed by one or both parties; some maintenance support by the distributor with additional maintenance by the developer; accounting duties on the distributor to determine royalties due; exclusive period or markets; audit rights held by the developer; and cross licensing of improvements (i.e., the developer gets to use distributor-developed improvements). P. Hoffman, The Software Legal Book § 5.4 (1986).
licensed from soon-to-be bankrupt software houses. In other words, the Lubrizol decision gives future software vendees a bargaining chip to use against certain types of vendors while increasing the risk that some current vendees might lose valuable software rights if their licensors become bankrupt.

The statutory basis for the court's holding was § 365 of the Bankruptcy Code. While this provision may seem necessary and easy to apply, the Lubrizol decision is troublesome in two areas. First, the court determined that an executory contract exists when a licensor owes certain minimal, contingent duties and a licensee owes a duty of accounting in addition to the mere obligation to pay money. Second, the court found a benefit to the bankrupt licensor in the rejection of a nonexclusive license. On the basis of such findings, rejection of the license was permitted.

This paper will first review the history of Section 365 so that the reasonableness of the Lubrizol decision can be scrutinized. The paper will then discuss the decision's effect on software licensing and present arguments in favor of limiting the scope of Section 365 to preclude its application to such unique items as computer software. Finally, the paper will present possible methods of negotiating or drafting around the problems presented by the Lubrizol decision.

II. THE CASE

Lubrizol involved the rejection in bankruptcy of a nonexclusive license of a metal coating process technology from Richmond Metal Finishers (RMF) to Lubrizol Enterprises (Lubrizol). Under the terms of the license agreement, RMF (the licensor) was required to notify Lubrizol (the licensee) of patent infringement actions involving the process and to defend it in those actions; to notify Lubrizol of any subsequent licenses involving the same process; and to reduce Lubrizol's royalty rate if a lower rate was charged to the other licensee(s). In addition, RMF was to indemnify Lubrizol for losses arising in connection with any misrepresentation or breach of war-

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7. Id. at § 365(a).
8. 756 F.2d 1043, 1046 (4th Cir. 1985).
9. Id. at 1047.
10. Id. at 1045.
Lubrizol owed RMF the duty of accounting for and paying royalties for use of the process and cancelling certain existing indebtedness. Furthermore, Lubrizol was not to use the process until May 1, 1983, and in fact, never did use the process.

RMF filed a Chapter 11 petition for bankruptcy on August 16, 1983, and, as part of its plan for reorganization, sought to reject the license agreement to facilitate sales or licenses to future customers. The bankruptcy court ruled that the contract was executory within the contemplation of 11 U.S.C. § 365(a) and permitted RMF to reject the license.

On appeal, the district court determined that the contract was not executory and, in any event, its rejection would not be advantageous to the bankrupt. The Fourth Circuit Court of Appeals reversed the district court's decision and reinstated the holding of the bankruptcy court permitting RMF to reject the license.

The Court of Appeals employed a two-step test in arriving at its decision. First, it decided whether the license agreement was executory. Second, if it found the agreement to be executory, it then sought to determine whether rejection would be advantageous to the bankrupt.

The Court of Appeals held that the license agreement was executory by employing Professor Countryman's definition of "executory." According to Professor Countryman, a contract is executory if the "obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete the performance would constitute a material breach excusing the performance of the other." In applying the test, the court found the agreement executory as to RMF because it owed the continuing duty of notifying Lubrizol of further licenses of the process and of lowering Lubrizol's royalty rate if a lower rate was charged for such licenses. In addition, the court found a continuing duty in RMF to apprise Lubrizol of any suits related to the process.

11. Id.
12. Id.
13. Id.
14. Id.
15. Id.
16. Id. at 1044.
17. Id.
18. Id. at 1045.
19. Id. at 1046.
20. Id. at 1045.
process and to defend and indemnify Lubrizol for any resulting losses.\(^\text{22}\)

The court also held that the contract was executory as to Lubrizol by finding that Lubrizol owed the continuing duty of accounting for and paying royalties to RMF.\(^\text{23}\) While the court acknowledged that the mere obligation to make payments of money does not make a contract executory, it held that the duties of Lubrizol went beyond the traditional monetary payment in that the accounting duty required Lubrizol to "deliver written quarterly sales reports and [to] keep books of account subject to inspection by an independent Certified Public Accountant."\(^\text{24}\) Since this duty was held to go beyond mere debt, the license was determined to be executory as to Lubrizol.\(^\text{25}\) Thus, since the license agreement was executory within the meaning of § 365(a), the Court of Appeals reversed the district court's contrary holding.\(^\text{26}\)

After deciding that the license was executory, the Court of Appeals considered whether rejection of the license would serve the bankrupt's business interests.\(^\text{27}\) The court began its analysis by recognizing the proposition that "the bankrupt's decision upon [whether rejection would be advantageous] is to be accorded the deference mandated by the sound business judgment rule as generally applied by courts to discretionary actions or decisions of corporate directors."\(^\text{28}\) In other words, the courts should not overturn the trustee's decision absent a finding of bad faith or gross abuse of "business discretion."\(^\text{29}\) Since the bankruptcy court failed to find any bad faith, the district court could reverse only if that finding was "clearly erroneous."\(^\text{30}\) The Court of Appeals overturned the district court's reversal because the court had failed to meet the "clearly erroneous" standard and had merely substituted its busi-

\(^22\) 756 F.2d 1045, 1045 (4th Cir. 1985).

\(^23\) Id. at 1046.

\(^24\) Id.

\(^25\) Id.

\(^26\) Id.

\(^27\) Id.

\(^28\) Id. The court refers to NLRB v. Bildisco, 465 U.S. 513, 523 (1984) (noting that the business judgment rule is the "traditional" test); Group of Institutional Investors v. Chicago, Milwaukee, St. Paul & Pacific Railroad, 318 U.S. 523, 550 (1943) (applying business judgment rule to bankrupt's decision whether to affirm or reject lease); Control Data Corp. v. Zelman (In re Minges), 602 F.2d 38, 43 (2d Cir. 1979) (applying Institutional Investors outside of railroad reorganizations); Carey v. Mobil Oil Corp. (In re Tilco, Inc.), 558 F.2d 1369, 1372-73 (10th Cir. 1977) (applying Institutional Investors to rejection of gas contracts).

\(^29\) 756 F.2d 1043, 1047 (4th Cir. 1985). See, e.g., Lewis v. Anderson, 615 F.2d 778, 782 (9th Cir. 1979); Polin v. Conduction Corp., 552 F.2d 797, 809 (8th Cir. 1977).

\(^30\) 756 F.2d 1043, 1047 (4th Cir. 1985).
ness judgment for that of the debtor.\textsuperscript{31}

The Court of Appeals concluded its opinion by setting out Lubrizol's rights after rejection and then responding to Lubrizol's policy arguments.\textsuperscript{32} Under 11 U.S.C. § 365(g), Lubrizol's only option was to treat the rejection as a breach and sue for money damages.\textsuperscript{33} It could not retain its contract rights and sue for specific performance.\textsuperscript{34} Recognizing that there were policy arguments against its decision, the court still dismissed them as typical of the hazards created by § 365 for all businesses dealing with potential bankrupts.\textsuperscript{35}

On March 3, 1986, the United States Supreme Court denied Lubrizol's petition for a writ of \textit{certiorari}, thereby leaving intact the Fourth Circuit's reversal.\textsuperscript{36} Thus, RMF, a bankrupt licensor, was permitted to reject its license agreement with Lubrizol as it was an executory contract governed by Section 365 of the Bankruptcy Code.

III. BACKGROUND

The bankruptcy system serves two primary objectives. The first goal concerns economic rehabilitation of debtors by restructuring the ratio between debts and assets or income.\textsuperscript{37} The second purpose is to establish a forum for orderly and equitable distribution of assets that optimizes recovery by creditors.\textsuperscript{38} Section 365(a) furthers these objectives by permitting debtors to reject those executory contracts which are burdensome or unproductive while completing those contracts which will provide a positive benefit to

\begin{itemize}
\item \textsuperscript{31} \textit{Id.}
\item \textsuperscript{32} \textit{Id.} at 1048.
\item \textsuperscript{33} \textit{Id.}
\item \textsuperscript{34} \textit{Id.}
\item \textsuperscript{35} \textit{Id.}
\item \textsuperscript{37} Nimmer, \textit{Executory Contracts in Bankruptcy: Protecting the Fundamental Terms of the Bargain}, 54 U. COLO. L. REV. 507, 509 (1983). The rationale for this goal can be described in relatively pure economic terms, focused on the supposition that economic rehabilitation preserves or recreates a functioning economic entity that is able to participate in economic exchange systems. \textit{Id}. Furthermore, especially in business cases, rehabilitation captures greater value for all concerned than would liquidation. H.R. REP. No. 595, 95th Cong., 1st Sess. 220 (1977), \textit{reprinted in} 5 U.S. CODE CONT. & AD. NEWS 5963, 6179-80 (1978); S. REP. No 989, 95th Cong., 2d Sess. 10 (1978), \textit{reprinted in} 5 U.S. CODE CONG. & AD. NEWS 5787, 5796 (1978).
\end{itemize}
In other words, the debts that would be created by requiring a bankrupt debtor to perform unprofitable executory contracts are reduced by permitting rejection. Furthermore, § 365(a) allows bankrupt debtors to have the best of both worlds by also permitting them to assume those contracts which will increase the income to the estate. By decreasing the amount of debt in this way while maintaining the level of income to the estate, Section 365 increases the amount of money available to the estate. This fund is then structured into payments to creditors in reorganization or distributed to creditors in liquidation. The end result is a more favorable repayment schedule for creditors and a step towards economic recovery for debtors.

Section 365 operates by allowing the bankruptcy trustee, "subject to the court's approval, [to] assume or reject any executory contract...of the debtor." Thus, the bankruptcy trustee is permitted to weigh the various costs and benefits of performing each executory contract. Based on each analysis, he may choose to perform those contracts which will be beneficial to the estate while rejecting those which will produce a net loss or a burden on the estate. The determinations are permitted on a case by case basis. In essence, the option to assume or reject is analogous to the trustee's right to abandon property which is burdensome or of inconsequential value to the estate.

The general theme underlying Section 365 is that the bankrupt's interest in dispensing with burdensome or inconsequential property outweighs any protectable interest that the nonbankrupt may have in the executory contract. If the trustee chooses to reject the contract, the nonbankrupt is limited to damages. Generally, this means that the nonbankrupt will not be fully compensated for his troubles and will be placed in the category of general creditors. These general creditors, in turn will share in the misfortune of the debtor's bankruptcy. Thus, although rejection of the contract is analogous to repudiation and breach of the agreement (in which case the nonbankrupt need not perform), his sole remedy is a claim.

40. Id.
41. 11 U.S.C. § 365 (1982 & Supp. II 1984) is called into question primarily in reorganization (Chapter 11) cases because the trustee in a liquidation (Chapter 7) case will generally reject all executory contracts automatically. In other words, a nonexistent entity generally does not have the option of assuming and continuing under its executory contracts.
42. In reorganization (Chapter 11) cases, the debtor generally serves as trustee and retains control over the estate, but under the watchful eye of the creditors.
44. Id. at § 554(a).
for monetary damages. As a consequence, the nonbankrupt cannot rely on any specific remedies provided for in the contract (e.g., specific performance).45

The threshold issue in applying Section 365 is determining whether the contract is executory. The legislature has never established a statutory definition of "executory" and therefore the definition must be developed by examining the cases in the bankruptcy area. Basically, an executory contract is one in which performance is due to some extent on both sides.46 Recently, the courts have adopted Professor Countryman's more specific test in order to determine whether a contract is executory.47 As noted earlier, according to Professor Countryman, a contract is executory if the "obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete the performance would constitute a material breach excusing the performance of the other."48 This definition is consistent with the case law except that a material breach may not be required.

A review of specific cases reveals how the definition of executory contracts applies to license agreements. It is clear that an exclusive license agreement will make a contract executory as to the party giving up his rights to the licensed technology.49 Furthermore, the judiciary has found that contingent duties are indicative of an executory contract.50 For example, an obligation to defend infringement suits gives rise to an executory contract as to the promisor.51 While these provisions make a license agreement executory, one court has noted that mere payments of money will not

47. Gloria Manufacturing Corp. v. International Ladies' Garment Worker's Union, 734 F.2d 1020, 1022 (4th Cir. 1984).
49. Fenix Cattle Co. v. Silver (In re Select-A-Seat-Corp.), 625 F.2d 290, 292 (9th Cir. 1980). In In re Select-A-Seat, the court found that an obligation of a debtor to refrain from selling software packages under an exclusive licensing agreement made a contract executory as to the debtor notwithstanding the continuing obligation was only one of forbearance. Id. Further, the court found that the obligation of the licensee to pay five percent of its annual net income, in addition to the one-time license fee of $140,000, made the licensee's end of the contract executory as well. Id.
51. In re O.P.M. Leasing Services, Inc., 23 Bankr. L. Rep. 104, 117 (Bankr. S.D.N.Y. 1982). A clause placing an obligation on the promisor to defend infringement suits is a classic example of a contingent duty which may make a contract executory. Such a clause typically recites that the promisor is the owner of the licensed software and that he or she will defend against any infringement suits brought by third parties claiming ownership in all or part of the same software. Although the situation contemplated by the clause may never arise, the
make a contract executory. As discussed before, the Lubrizol court carried this point a step further by recognizing that although mere payments are not enough, an executory contract will arise as to a licensee that owes an additional duty of accounting. While the Lubrizol type of accounting duty is uncommon in typical end-user software licenses, such a duty often arises in OEM/VAR agreements and situations involving embedded software. Thus, an assertion that all OEM/VAR agreements are executory contracts would be consistent with the Lubrizol holding.

The judiciary has focused on the “court approval” element of § 365(a) since its inception. Various courts have attempted to define the extent of judicial review and the character of the economic standard to be met in implementing a decision to reject executory contracts. While some courts have required proof that the contract is burdensome (e.g., costs exceed benefits), the vast majority have deferred to the trustee’s decision. However, the trustee must still determine that rejection would benefit the general unsecured creditors of the estate. While the rights of the nonbankrupt licensee may be considered, rejection will be denied by the court only when the damages to the nonbankrupt are disproportionate to any benefit received by the unsecured creditors. The standard of review for this decision is the “business judgment” test. Under this test, the trustee’s decision to reject will be upheld unless the court finds bad faith or gross abuse of “business discretion.” Finally, the standard for appellate review of such a decision is the “clearly erroneous” standard. Thus, it appears that a significant abuse of discretion resulting in an actual loss to the estate must be established before a trustee’s decision to reject will be overturned.

judiciary still labels the duty as continuing. Consequently, the contract will be considered executory as to the promisor.

53. 756 F.2d 1043, 1046 (4th Cir. 1985).
54. “Imbedded software” describes the software added to a distributor’s existing software to make up a single software product. The developer of the imbedded software will retain ownership of his part of the product and will receive royalties from the distributor based on the amount and scope of licenses granted.
57. Control Data Corp. v. Zelman (In re Minges), 602 F.2d 38 (2d Cir. 1979).
59. See supra note 27.
60. See supra note 28.
61. 602 F.2d 38, 43 (2d Cir. 1979).
IV. Analysis

The Bankruptcy Code is designed to establish an efficient procedure in insolvency so that distressed debtors may receive a fresh start. A strict application of Section 365 easily accomplishes this internal goal by permitting the debtor to reevaluate his executory contracts and unexpired leases so as to maximize the funds available for distribution to creditors while minimizing burdensome obligations. A problem arises when this internal goal conflicts with the external goal of encouraging certain types of voluntary transactions. If the court permits rejection of executory contracts without looking at the overall commercial effect, the result might weaken the general social norm that honestly incurred obligations should be voluntarily performed.

The Lubrizol court’s extension of Section 365 conflicts with several strong external policies. By finding that Lubrizol’s accounting duty was executory, the court could conceivably render every OEM/VAR agreement executory because such agreements generally require that the distributor maintain records of each license granted so that the amount of royalties payable may be ascertained and verified. The nonbankrupt’s continued use of certain vital technology may weigh heavily against rejection. In these cases, the trustee should be held to a higher standard before rejection is permitted. In Lubrizol, the trustee should have been required to show a clear benefit to the estate. Moreover, he should have been compelled to show that future performance by RMF might result either in a net loss to the estate or in a need to continue the business beyond the period that would be feasible for an orderly distribution of assets. Based on the facts given, there would have been no net loss to the estate because the license was nonexclusive and the debtor was free to license the process to other licensees. Furthermore, the trustee could not show a burden on the estate because RMF’s continuing duties were minimal.

A. Contract Objectives

The law of contracts is based on a promotion of voluntary agreements between parties. The value of a contract is enhanced significantly when it represents good faith negotiations by the parties and is enforceable with some degree of reliability. In this vein, parties should be allowed the freedom to contract for those terms which will further each party’s business interests. Contractual remedies should be permitted to further this goal where not inconsistent with other significant policy objectives. This plan ensures that the in-
jured party will receive the benefit of its bargain in most situations according to the contract’s terms.

If negotiating is the key to a successful contract, then each party’s ultimate satisfaction will be directly proportional to his level of bargaining strength. In turn, the financial stability of each party directly and substantially affects each party’s bargaining strength. The value of the contract to each party is controlled by “the value of the ultimate exchange discounted by the certainty or uncertainty of performance by the other party.”62 In a comment to Section 2-609, the Uniform Commercial Code recognizes that:

A continuing sense of reliance and security that the promised performance would be forthcoming when due, is an important feature of the bargain. If either the willingness or the ability of a party to perform declines materially . . . the other party is threatened with the loss of substantial parity of what he has bargained for.63

In light of Section 365’s impact on executory contracts, parties must now ask whether bankruptcy is foreseeable during the term of a negotiated contract. If no risk of bankruptcy is perceived, Section 365 will have no influence on a contract’s enforceability. Thus, the bankruptcy contingency is defined by what can happen in bankruptcy and the extent to which bankruptcy is perceived to be likely.

The goals represented in the Bankruptcy Code should not be entirely inconsistent with the goals of general contract law. Some of the internal bankruptcy goals include optimal distribution to creditors and giving insolvent debtors the chance for a fresh start. However, the Bankruptcy Code should also reflect the external goal of keeping parties out of bankruptcy. It could enhance the ability of a nonbankrupt but financially distressed debtor to engage in business activities that would avoid bankruptcy. The Code can accomplish this by not further weakening the bargaining position of a financially unstable party. Thus, courts which apply Section 365 must balance the internal bankruptcy goals with the general contract principles that encourage and reenforce the use of contractual relationships.

As applied in the Lubrizol decision, Section 365 conflicts with basic contract principles. The judiciary must recognize that Section 365 will affect contracts even if bankruptcy is never filed. For example, the primary impact of Section 365 is felt by the smaller, financially distressed debtor in that third parties may refuse to enter

into contractual relationships with them based on the fear that bankruptcy will deny these parties the benefit of their bargain. Moreover, even if these financially distressed entities are able to persuade third parties to deal with them, the cost in terms of a loss of bargaining strength will be significantly increased.\footnote{64}

The Lubrizol decision will not affect general end-use license agreements for computer software since such agreements are nonexecutory and cannot be rejected. Although the vendor will typically owe some continuing duties in standard end-user agreements such as the contingent duty to defend the vendee in any infringement actions, the vendee will generally not owe any continuing duties after the initial license fee has been paid. Such agreements are nonexecutory and cannot be rejected. On the other hand, several types of software agreements will almost always be executory and, thus, subject to the Lubrizol analysis. Virtually all OEM/VAR agreements will be executory because the typical licensee owes a duty, not unlike Lubrizol's, of accounting for further distributions of the software and paying royalties based on the number and type of licenses granted. Lubrizol would also apply to those licenses which require the vendee to make certain improvements to the software and then license those improvements back to the vendor. These situations are not uncommon in the software field and will almost always result in executory, and therefore rejectable contracts under Lubrizol.

The major impact of the Lubrizol decision will fall on the smaller vendors which license their software under one of the above situations. These companies tend to exist solely to develop and license individual software products. They make their money by licensing their product to multiple users under license agreements that may contain reciprocal duties similar to those involved in the Lubrizol decision. Furthermore, they generally operate at a loss during the development stages of the software. The problem arises because license agreements are generally negotiated either prior to or during this development stage and this is precisely the time when Section 365's impact will be felt the greatest by these smaller vendors.

\footnote{64. To the extent that the value of a contract decreases, the affected party will have an increasing incentive to negotiate terms or act in a manner that reduces the possibility of nonperformance, limits the extent of that party's potentially adverse reliance on the promise, or increases the value of the ultimate exchange to that party. Nimmer, supra note 37, at 521. Often, these actions will increase the cost (or reduce the value) of the contract to the other party. Id. Depending on the facts or the behavioral model employed, these adjustments may lead to a refusal to undertake a contractual arrangement. Id.}
General contract norms do not provide the entire basis for limiting the application of Section 365 when the continuing commercial viability of small software vendors is at issue. A further reason is that the ability of these parties to contract on commercially viable terms might even be essential to any effort by them to avoid financial failure and eventual bankruptcy. So, if Lubrizol is applied strictly, Section 365 will disrupt contract patterns and may actually contribute to the likelihood of bankruptcy. Thus, the potential snowball effect of the Lubrizol decision should be stopped before a significant amount of damage is done to the computer industry.

B. The “Court Approval” Requirement

The Lubrizol case reversed the district court’s holding under the guise that it was protecting the trustee’s right to exercise his business judgment in deciding whether or not to reject RMF’s license of Lubrizol. It held that the trustee’s business judgment of what constituted a burden on or a loss to the estate should be interfered with only where “clearly erroneous.” Even assuming the business judgment standard was applied properly in this situation, the basis for the court’s holding could only have been that Lubrizol failed to offer any contrary evidence at the bankruptcy court level or that the district court failed to directly quote the term “clearly erroneous.” Under the facts given, the decision of the trustee in the Lubrizol decision was clearly erroneous.

Rejection of the license to Lubrizol not only failed to reduce a potential burden on the estate, it actually created a loss to the estate. As discussed before, the license involved in the Lubrizol case was non-exclusive. Under a typical non-exclusive license, the licensor is free to license the technological process to other parties. Thus, RMF could not argue that its license to Lubrizol reduced its opportunities to contact further potential licensees unless additional information was given. Such information might include an assertion that the market for the process was so limited that by rejecting the license to Lubrizol, greater opportunities would open up with Lubrizol’s competitors. Since the royalty payments appear to be based on use, RMF could then assert that one or more of the competitors would use the process more than Lubrizol. Such a situation would produce a definite monetary benefit to the estate. However, RMF apparently only argued that if it granted a license to a future party for less than the license fee paid by Lubrizol, it would have to

65. 756 F.2d 1043, 1047 (4th Cir. 1985).
reduce Lubrizol's royalty rate accordingly. In this situation, the only resulting loss that would occur by continuing the Lubrizol license would be a reduction in the royalty amount paid by Lubrizol alone. Following this line of reasoning, RMF's rejection would result in a greater loss to the estate in the amount of Lubrizol's entire royalty payment. Although this discussion does not take into account the further duties RMF would owe if it continued the license to Lubrizol, clauses of similar effect would probably be included in any other license granted by RMF. Thus, they would not represent any increased burden upon the estate.

The current standards for judicial approval grant the trustee substantial discretion in a decision to reject. While this approach tends to optimize the value of estate, it also weakens the value of any contractual promise made by a financially distressed debtor facing a significant risk of bankruptcy. As a result of the business judgment standard and the reduced likelihood of court reversal, the decision to reject may increase the cost and reduce the availability of license agreements for such debtors, thereby actually contributing to further financial hardship.

The problems resulting from Lubrizol's interpretation of the business judgment standard will be compounded when applied to various types of licenses for specially designed computer software. This raises the question of when a significant harm to a nonbankrupt party should be allowed to override a trustee's decision to reject a contract. Furthermore, while the business judgment standard may be acceptable with generally available items, it is generally inappropriate when dealing with such unique items as specially designed software. In the situation of important, specially designed software, the rejection standard should provide a greater assurance of performance.

Under the general contract principles, the breach of a contract for unique goods may result in the remedy of specific performance. The Bankruptcy Code recognizes the importance of contracts for unique items by removing real estate contracts from the general application of Section 365. In those situations, a form of specific performance is permitted. Certain computer software licenses are no different from contracts for real estate in that the software may be just as important and just as unique to the nonbankrupt party.

66. RMF would still have the contingent duty of notifying and defending any patent infringement actions and indemnifying Lubrizol for any losses arising in connection with a breach of warranty or misrepresentation. Id. at 1045.

The Code should reflect this concern, or, alternatively, bankruptcy judges should consider this situation when deciding whether or not to approve rejection of a computer software license. Where the nonbankrupt party's interest in continued use of the computer software significantly outweighs any burden on the bankruptcy estate and where there is no open commercially reasonable substitute for the software, rejection should not be permitted.

The judicial approval requirement of Section 365 should also be applied to minimize the impact on pre-bankruptcy bargaining for computer software while avoiding substantial damage to other bankruptcy interests. Although there should be no blanket grant of specific performance, it should be allowed where certain conditions are established. These factors could be reviewed at the "judicial approval" stage of the bankruptcy proceedings. Professor Raymond Nimmer has suggested a three factor test in determining whether rejection should be approved or disapproved.\(^6\) First, will performance be burdensome on the bankrupt estate?\(^6\) Here, the court should look for any immediate economic loss to the estate caused by future performance of the executory contract. Second, is performance feasible?\(^7\) In this situation, no specific performance of an agreement should be granted if performance would be impossible. This situation might arise in liquidation cases where the license agreement provides for future maintenance. Third, what is the extent of the nonbankrupt's reliance on the contractual promise?\(^7\) Under these circumstances, reliance is construed broadly and the court should merely ask whether the nonbankrupt has begun to act on the promise or whether there are commercially viable alternatives. If this test is applied before permitting rejection of computer software licenses, the negative impact on small computer software vendors will be greatly reduced.

V. DRAFTING AROUND LUBRIZOL

*Lubrizol* will probably not result in special sessions of the legislature. Thus, it is important for computer lawyers to consider the bankruptcy contingency in drafting any computer software license agreements. Although there are no ironclad methods of avoiding Section 365 and the rejection of executory contracts, there are several possible options which might either limit the applicability of

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69. Id.
70. Id.
71. Id.
Section 365 or reduce the potential harm to the vendee in the event that rejection is permitted.

The source code of a computer program is the standard representation of the instructions that cause a computer to execute a desired function. It typically contains comments on the operation of the software and enables a computer programmer to understand how the software works. Thus, a software vendee may protect itself by demanding the source code up front. However, such a demand is generally inappropriate in negotiating a license to use standard software because either the software is not significant enough to warrant such a demand or the vendee may have neither the ability nor the desire to perform maintenance using the source. On the other hand, if the software is very important, the customer may be justified in demanding access to the source code in the event that the vendor goes bankrupt or fails to provide continued maintenance.

Release of the source code also permits the vendee to make its own modifications and improvements to the software. Thus, with access to the source code, the vendee ensures itself of continued use of the software. On the other hand, it also increases the likelihood that the vendor's proprietary rights could be infringed. For these reasons, vendors are very reluctant to release source codes to their customers. This holds true whether the vendor is a large, well-established software development firm or a small, financially unstable software house. Thus, although the vendee may attempt to get the source code, such a solution would be unlikely in the majority of cases.

A well-drafted source code escrow agreement is perhaps the best method a vendee can employ to protect itself if vendor bankruptcy is a concern. An escrow arrangement allows the vendee to obtain access to the source code if and when the vendor is unavailable to provide a copy to the vendee. However, such an arrangement will only work if the escrow agreement is not an executory contract for purposes of the Bankruptcy Code.

One possible arrangement involves two documents: a non-executory escrow agreement and a concededly executory license agreement. In this situation, the license agreement provides the general working relationship between the vendor and the vendee, and is rejectable by the trustee as an executory contract. On the other hand, the escrow agreement must only provide for the con-

72. For a general introduction to source code escrow agreements, see P. HOFFMAN, THE SOFTWARE LEGAL BOOK § 2.42 (1987).
continuing duties owed by the escrow agent (stakeholder) and should not be executory. Careful consideration must be given to the drafting of the escrow agreement for this arrangement to work.

The escrow agreement will continue after bankruptcy only if the vendor owes no continuing duties under the agreement. Thus, the escrow agreement should only establish the responsibilities of the stakeholder and the escrow fees should be paid up front. The vendor obligation to deposit updated versions of the software into escrow should not be in the agreement, nor should any requirements be placed on the vendor with respect to the future deposits. Finally, the vendor should not have any obligations with respect to release of the software upon bankruptcy or failure to maintain. In sum, the escrow agreement should be drafted so that the trustee cannot make a successful argument that the vendee owes a continuing duty.

The escrow agreement can probably state that the vendor will provide a list of vendees (potential distributees) to the stakeholder. However, this clause must in no way place an obligation on the vendor to keep such a list current. The burden should be on the individual vendees to remind the vendor to update the stakeholder's list. Thus, the actual clause in the escrow agreement will be read more as an assertion by the vendor than as an obligation placed on the vendor.

The source code will generally be transferred to the stakeholder on some form of medium (e.g., tape, diskette, etc.). The drafter of an escrow agreement should make certain that the stakeholder has title to the medium even though the vendor will almost invariably retain title to the source code. The purpose of such a provision is to circumvent Section 542 of the Bankruptcy Code. Section 542 gives the trustee the power to compel a third party in possession of property of the estate to turn such property over to the trustee.73 If the vendor owned the diskette in the stakeholder's possession, the trustee could demand its return and frustrate the purpose of the agreement. A stakeholder with title to the diskette is then free to transfer it to the vendee upon the occurrence of the stated conditions. It is important to note that the stakeholder does not own the source code and therefore, cannot make copies of it after the vendor enters bankruptcy. Thus, the stakeholder must be holding enough copies to distribute to each of named vendees.

The escrow agreement should also contain a description of the events which trigger a release of the source code to the named vend-

ees. Once again, this procedure should not place any obligations on the vendor. However, notice and an opportunity to object (with procedures for determining whether the triggering event has occurred) given to the vendor should not make the agreement executory. Either the license agreement or the escrow agreement can provide that each named vendee will receive information on the release events and procedure from the stakeholder.

To keep the escrow agreement from being deemed executory, the drafter of the agreements must distinguish between a triggering event and an obligation not causing default. Examples of triggering events include the appointment of a receiver for the vendor, the filing of a petition for bankruptcy, and vendor failure to provide required maintenance. The escrow agreement should stop with a definition of these triggering events. The license agreement, on the other hand, should actually set forth the vendor's obligation to maintain the software, to remedy defects, and to deposit updated versions of the software into escrow. The logic is that if the license agreement is going to be deemed executory, it might as well be executory.

A discussion of every provision that might go into a license agreement or an escrow agreement is beyond the scope of this article. With desired additions, the drafter should just remember that any obligations placed on the vendor should be in the license agreement rather than in the escrow agreement. Vendor duties under the escrow agreement should be limited to the initial payment of fees and the initial deposit of the source code (with title to the medium in the stakeholder). In this form, the agreements should protect the vendee from loss in the event of vendor bankruptcy as long as the drafter takes these general rules into account.

VI. CONCLUSION

The *Lubrizol* decision has a direct impact on the computer software industry. Software vendees may be more reluctant to deal with small software vendors whom they perceive to be financially unstable. Alternatively, if the software is very important and vendees can perform their own maintenance, they may escalate their demand for source code or some type of escrow arrangement through which they are guaranteed continued access to the source. Even if the vendee does not have the luxury of shopping elsewhere or the leverage to obtain the source code up front, the *Lubrizol* decision is a warning that careful drafting should be employed during the negotiating process.
The drafter should recognize that two distinct agreements are required when the source code is to be placed in escrow. The first will be a source code escrow agreement that cannot be interpreted as executory. The drafter should take great pains in making sure that the agreement is not executory by not including any provisions that may be interpreted as placing a continuing duty on the vendor. The second agreement is the concededly executory license agreement which may contain all of the desired vendor duties. If this distinction is recognized, the vendee should attain a higher level of protection if the vendor is thrust into bankruptcy.