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CONFERENCE PROCEEDINGS

Software Escrow in Bankruptcy: An International Perspective

John M. Conley*
Robert M. Bryan**

I. Introduction

The large damage awards received by business computer users in several recent cases¹ reflect the degree to which a business may become dependent on its computer system. The computer system may entirely control critical functions such as production, inventory control, distribution, and payroll. For most businesses, the applications software² that meets day-to-day business needs represents the most important and most vulnerable component of the system.³ Because software, particularly custom-developed software, often requires both regular maintenance and updating to meet changing

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¹ See, e.g., *Glovatorium, Inc. v. NCR Corp.*, 684 F.2d 658, 663-64 (9th Cir. 1982) (\$275,000 in compensatory damages and over \$2 million in punitive damages); cf. *Computer Sys. Eng'g, Inc. v. Qantel Corp.*, 740 F.2d 59, 62-63 (1st Cir. 1984) (almost \$5 million awarded to distributor of computer system in suit against manufacturer).

² The term "hardware" is generally used to refer to computer machinery, while "software" is used to refer to the encoded instructions or programs that control the operations of the hardware, together with data being stored on the computer. See generally Keplinger, *Computer Software—Its Nature and Protection*, 30 EMORY L.J. 483, 484-88 (1981). A distinction is often drawn between operating or systems software and applications software. Operating or systems software controls the basic functioning of the hardware and makes the hardware generally available for the range of specific uses to which it may be put. Applications software, interacting with the operating software, causes the computer to carry out such specific tasks as printing a document, computing an average, or doing a word search within a body of case law. See *Apple Computer, Inc. v. Franklin Computer Corp.*, 714 F.2d 1240, 1243 (3d Cir. 1983), cert. dismissed, 104 S. Ct. 690 (1984). In lawyers' terminology, it would not be inaccurate to describe operating software as "procedural" and applications software as "substantive."

³ See, e.g., *Glovatorium*, 684 F.2d at 661-62 (failure of computer system intended to perform payroll and "routine accounting" functions); *Dunn Appraisal Co. v. Honeywell Information Sys., Inc.*, 687 F.2d 877, 879 (6th Cir. 1982) (failure of computer system intended to manage auto appraisal business).

business demands, the business customer may become dependent on the software provider as well as on the software.⁴ Thus, the user has a vital interest in ensuring that someone will be able to perform the maintenance and update functions if the software provider ceases to do business.

The proprietor of a software package has another set of concerns that sometimes conflict with those of the user. Most software proprietors have a vital interest in protecting their research and development investment by preventing others from misappropriating their technology. One way to accomplish this is to distribute to users only the materials necessary to run the software, while withholding additional materials that might assist someone in copying or recreating it. Thus, users often receive less information than necessary to take over the maintenance and update functions should the proprietor go out of business.

"Source code escrow" is a label that applies to a variety of arrangements designed to reconcile the conflicting interests of user and proprietor. The purpose of such arrangements is to provide the user with access to the material necessary to maintain and update the software if the proprietor fails to do so, without significantly increasing the risk of misappropriation of the software and the intellectual property that it may embody.⁵

This article deals with the major and still unresolved legal issue that has arisen in connection with source code escrow arrangements: whether the user can enforce the arrangements in the event of the proprietor's bankruptcy. While it is impossible to be certain about the enforceability of any escrow arrangement, whether domestic or international, the prospects for enforcement are greatly enhanced if the arrangement reflects an understanding of the underlying statutory and policy issues.

II. The Domestic Perspective

A. The Problem

A written version of a computer program, whether printed on paper or stored electronically on a disk or chip, is generally referred to as code. There are two principal types of code: source code and object code.⁶ Programmers typically write software in source code. Source code is written in a high-level programming language that

⁴ See, e.g., *Dunn Appraisal*, 687 F.2d at 879 (reliance on vendor to convert purchaser's business to new computer system); *Napasco Int'l, Inc. v. Tymshare, Inc.*, 556 F. Supp. 654, 656-57 (E.D. La. 1983) (reliance on vendor to tailor "modular" computer system to customer's needs).

⁵ See *infra* notes 6-17 and accompanying text.

⁶ See generally *Apple Computer*, 714 F.2d at 1243; Davidson, *Protecting Computer Software: A Comprehensive Analysis*, 23 JURIMETRICS J. 339, 340-42 (1983).

resembles English⁷ and that another programmer readily can understand. Object code is the version of the program that the computer executes. Because it is encoded in machine readable language, object code usually is difficult for a programmer to decipher. Compiling is the process of translating a program written in source code into object code that a machine can execute. A compiler, which is a separate program, usually aids in this process.⁸ Decompilation, or translation from object code back to source code, is a far more difficult process, but improvements in technology are making it easier.⁹

In most cases, the object code version is both sufficient and necessary to run a particular program. For most users, however, examination of the object code reveals little about the nature of the program; source code is necessary for this purpose. In particular, access to source code is essential for the user to develop the understanding necessary to take over the maintenance and update functions. Therefore, it is reasonable for a user whose business will become dependent on a software package to insist on receiving the software in both object code and source code form, or at least on access to the source code if the proprietor defaults on its maintenance and update obligations.

The reason many proprietors are unwilling to distribute source code, however, is its utility in understanding how a program works.¹⁰ Access to source code can have tremendous practical value to one who seeks to misappropriate a program. If the goal is to copy the program,¹¹ information derived from studying the source code can

⁷ FORTRAN, BASIC and PL/1 are examples of high-level programming languages. See generally Davidson, *supra* note 6, at 341.

⁸ See *id.* at 341-42.

⁹ See *id.*; Laurie & Everett, *Protection of Trade Secrets in Object Form Software: The Case for Reverse Engineering*, COMPUTER LAW., July, 1984, at 1-4.

¹⁰ A number of people commenting on the conference presentation of this article pointed out that reluctance to distribute source code is a relatively recent development. In the early days of the computer industry, software was often given away without any retention of intellectual property rights in an effort to promote hardware sales. In recent years, however, as the cost of hardware has declined dramatically, enormous investments have been made in software development. See *Parker v. Flook*, 437 U.S. 584, 587 n.7 (1977); Brooks, *Agreements with Consultants and Employees and Registering Copyrights in Computer Software*, in 1 COMPUTER LAW 1982: ACQUIRING COMPUTER GOODS AND SERVICES 9, 193-94 (P.L.I. 1982), and software has come to represent the bulk of the cost to the end user of a computer system. See J. SOMA, THE COMPUTER INDUSTRY 28-30 (1976). In recognition of its economic value, software is now routinely distributed only pursuant to license agreements that restrict the time, place, and manner of use. See, e.g., *S&H Computer Sys., Inc. v. SAS Inst., Inc.*, 568 F. Supp. 416, 420-21 (M.D. Tenn. 1983). As a result of the same trend, few software vendors now regularly distribute their programs in source code form.

¹¹ A software author's protection against copying derives from the Copyright Act of 1976, as amended, 17 U.S.C. §§ 101-810 (1982). Copyright protection subsists in "original works of authorship," *id.* § 102(a), which have been held to include computer programs. *Apple Computer*, 714 F.2d at 1240. The exclusive rights of the copyright holder include the rights "to reproduce the copyrighted work" and "to prepare derivative works based upon the copyrighted work." 17 U.S.C. § 106(1)-(2). For a general review of copyright protection of computer software, see Davidson, *supra* note 6, at 360-95.

be useful in making simple, nonfunctional changes in the pirated program to help disguise the copying.¹² If the plagiarist does not intend to copy but rather intends to borrow ideas, concepts, and programming methods for use in preparing a competing program, the source code will be an invaluable reference material.¹³

Also, distribution of source code may have adverse legal consequences for the proprietor. If the proprietor depends solely on copyright for intellectual property protection, disclosure of source code to customers and transfer of title in copies of the source or object code will be legally immaterial.¹⁴ The proprietor who seeks trade secret protection for the software, either in addition to or in lieu of copyright protection, however, must carefully control access to source code.¹⁵ As a general rule, customers should gain access to the code only pursuant to a license agreement that strictly limits use and further disclosure of the code and the ideas and concepts it embodies.¹⁶ The sale or other transfer of title to copies of the code is inconsistent with the retention of trade secret rights.¹⁷

Thus, a software proprietor may have a twofold incentive to restrict access to source code: uncontrolled access may create legal problems for a proprietor who treats the software as a trade secret

¹² Such conduct was alleged in *SAS Institute*, 568 F. Supp. at 423. Since a showing of "substantial similarity" between the protected work and the accused work is the traditional means of proving copyright infringement, enough superficial changes in a plagiarized work may sometimes permit an otherwise culpable defendant to escape copyright liability. *See id.* *See generally* 3 M. NIMMER, NIMMER ON COPYRIGHT § 3.03 B, at 13-43 (1984 ed.).

¹³ Because copyright protection extends only to expression and not to underlying ideas, 17 U.S.C. § 102(b) (1982), copyright law does not prohibit the type of appropriation described in the text. A software proprietor concerned about the appropriation of ideas and concepts may seek legal protection by distributing the software only pursuant to a license agreement that forbids such conduct, and may create a practical barrier by refusing to distribute the source code, which is a competing programmer's best guide to the structure and function of the protected software. *See generally* Davidson, *supra* note 6, at 395-400.

¹⁴ *Cf.* 17 U.S.C. § 109 (1982) (lawful owner of copy of copyrighted work entitled to sell or otherwise dispose of that copy without permission of copyright holder).

¹⁵ Perhaps the most widely cited definition of a trade secret is that set forth in comment (b) to § 757 of the RESTATEMENT (FIRST) OF TORTS. *See* 12 R. MILGRIM, TRADE SECRETS § 2.01, at 2-3 n.2 (1983) and cases cited therein. According to comment (b), one of the factors in determining whether a particular piece of information constitutes a trade secret is "the extent of measures taken by the proprietor to guard the secrecy of the information." *Id.*

¹⁶ *See SAS Institute*, 568 F. Supp. at 420-41; *J&K Computer Sys., Inc. v. Parrish*, 642 P.2d 732, 735 (Utah 1982). *But cf.* *Videotronics, Inc. v. Bend Elecs.*, 1984 Copyr. L. Dec. (CCH) ¶ 25, 579 (D. Nev. Apr. 26, 1984) (distinguishing *J&K Computer* and finding no trade secret, because of unrestricted distribution).

¹⁷ Even if the code is subject to copyright protection, once title to a copy passes to a third party, he or she is free to dispose of that copy at will. *See* 17 U.S.C. § 109(a) (setting forth the so-called "first sale doctrine"). *Cf.* 17 U.S.C. § 109(c) (right of disposal conferred by subsection (a) does not accrue to possessor of copy who does not own it). Once a copy thus has made an unrestricted entry into the stream of commerce, it is unlikely that the proprietor any longer will be able to demonstrate that the secrecy of the code is being adequately guarded. *See supra* note 15.

and will facilitate plagiarism. "Software escrow" is the label given to a variety of arrangements designed to reconcile the concerns of the proprietor with the often conflicting, but equally legitimate concerns of the user. Although the structural details may differ, these arrangements have the common purpose of putting source code in the hands of a reliable third party who will make it available to the user or the user's designee only if the proprietor defaults on its maintenance or update obligations.

From the user's perspective, an adequate escrow arrangement must meet four criteria. First, the proprietor must deposit with the third party source code and supporting documentation sufficient to give the user or its designee a thorough understanding of the software. Second, the proprietor must update the deposit whenever changes are made in the software. Third, a technically competent party must verify the adequacy of the proprietor's deposits. Finally, there must be an immediate turnover of the deposited material to the user or its designee if the proprietor defaults on its obligations for any reason, including bankruptcy. From the proprietor's perspective, the principal goals are to insure the security of the deposited materials, for both practical and legal reasons, and to avoid the transfer of title to any copies of the code.

These arrangements regularly employ a number of options to meet these needs.¹⁸ Some agreements call for a traditional escrow agent, such as a bank or law firm, to hold a copy of the source code and to release it upon proof by the user that the proprietor is in bankruptcy or has otherwise ceased to do business. Other agreements provide more elaborate definitions of the disability of the proprietor and impose varying standards of proof on the user seeking access to the code. Others call for the escrow agent to turn over the code to a designee of the user approved in advance by the proprietor, who will then perform the maintenance and update functions for the user's benefit. There is a recent trend toward computer consulting companies holding themselves out as professional escrow agents. These companies advertise their ability to provide secure source code storage, to verify that the proprietor is meeting its deposit obligations, and ultimately to perform any maintenance and update work required by the user.¹⁹

Despite their superficial differences, these arrangements share the goal of providing source code access to the user if the proprietor defaults on its maintenance and update obligations. The financial demise of the proprietor is perhaps the most readily foreseeable

¹⁸ For a useful introduction to the practicalities of source code escrow, see Nycum, Kenfield & Keenan, *Debugging Software Escrow: Will It Work When You Need It?*, 4 *COMPUTER L.J.* 441, 443-47 (1984).

¹⁹ See *id.* at 447.

cause of such a default. Therefore, any escrow arrangement should provide that the necessary source code access will not be cut off by the insolvency and subsequent bankruptcy of the proprietor, because some provisions of American bankruptcy law threaten source code access when the proprietor is in bankruptcy.²⁰

B. United States Bankruptcy Law

In a bankruptcy proceeding that contemplates the continued operation of the debtor's business,²¹ it is likely to be in the debtor's interest to keep license agreements and related source code escrows in place. If, however, the proceeding will liquidate the debtor²² or greatly reduce the scope of its business, the trustee's primary concern will be to maximize the value of estate property, including intellectual property. Source code that remains outside the estate will reduce the value of any intellectual property being sold by the estate. Under these circumstances, the trustee of a software proprietor may have an incentive to reclaim any source code in the possession of users, escrow agents, and other third parties.

Under the current United States Bankruptcy Code,²³ the trustee has three principal avenues to limit postbankruptcy source code access. First, if the court deems the entire escrow arrangement to be an executory contract, it may lie within the discretion of the trustee to reject it and reclaim the escrowed code.²⁴ Second, if the court deems the escrowed code to be property of the debtor's estate,²⁵ the trustee may have the right to prohibit transfer of the source code or to reclaim code that the debtor transferred after or immediately prior to the filing of the bankruptcy petition. Third, the automatic stay provision of the source code²⁶ may preclude efforts by the user to gain access to the code after bankruptcy.

Each of these bankruptcy problems will be examined in detail. For purposes of this discussion, assume that the user has received object code pursuant to a license agreement, that the source code has been placed in the hands of a third party pursuant to an escrow contract that calls for user access if the proprietor defaults on its maintenance and update obligations, and that the proprietor has be-

²⁰ The potential impact of state insolvency laws on source code escrow is beyond the scope of this article. Nonetheless, a lawyer structuring an escrow arrangement may wish to review the insolvency laws of the state or states where the proprietor is located and the escrowed code is held.

²¹ See 11 U.S.C. §§ 1101-1120 (1982).

²² See *id.* §§ 701-766.

²³ Bankruptcy Code of 1978, 11 U.S.C. §§ 1-151104 (1982), as amended by the Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333 (1984).

²⁴ 11 U.S.C. § 365. See *infra* notes 28-52 and accompanying text.

²⁵ 11 U.S.C. §§ 541-543. See *infra* notes 53-80 and accompanying text.

²⁶ 11 U.S.C. § 362. See *infra* notes 82-95 and accompanying text.

come insolvent, has defaulted on its obligations, and is now in bankruptcy.

1. Executory Contracts

Section 365(a) of the Bankruptcy Code²⁷ permits the bankruptcy trustee²⁸ to affirm or reject executory contracts previously entered into by the bankrupt. The trustee may be able to reject an entire contract even though certain discrete elements have been fully performed.²⁹ Some courts have permitted the trustee to reject contracts in the exercise of reasonable business judgment,³⁰ while others have required a showing that performing the contract would impose an undue burden on the estate.³¹ Pursuant to section 365(b),³² if the debtor is in default on its obligations under an executory contract at the time of bankruptcy, the trustee cannot affirm and assume the obligations of the contract without a cure of the present default and adequate assurances of future performance.³³ Section 365(f)³⁴ provides that when the trustee properly assumes the contract and gives adequate assurances of future performance, he may assign the contract regardless of any objection by the other party or any prohibition on assignment in the contract. Section 365(c)³⁵ creates the

²⁷ 11 U.S.C. § 365(a). The section does not define executory contracts. The definitional question is discussed *infra* at notes 40-47 and accompanying text.

²⁸ The role of the trustee is defined in 11 U.S.C. §§ 321-331.

²⁹ The Bankruptcy Act of 1898, § 70(b), 30 Stat. 544, 566, *repealed by* Bankruptcy Act of 1978, 11 U.S.C. §§ 1-151326 (1982) [hereinafter cited as Bankruptcy Act of 1898] authorized the trustee to reject contracts that were "executory in whole or in part." This language was generally interpreted as permitting rejection of an entire contract as executory regardless of partial performance or performance of severable parts. *See, e.g., In re Universal Medical Serv.*, 325 F. Supp. 890 (E.D. Pa. 1971) (contract for delivery and installation of floor rejected in entirety even though delivery complete before bankruptcy).

Section 365 of the current Code generally preserves intact the trustee's power to reject under former § 70b. It does not, however, contain the "in whole or in part" language of the former section. Nonetheless, there is nothing in the legislative history to suggest that this omission was intended to reduce the trustee's power, and the prudent operating assumption is therefore that the trustee retains the power to reject an entire executory contract, even if performance is partially complete. *See In re Meadows*, 39 Bankr. 538, 540 (Bankr. W.D. Ky. 1984) ("Case law demonstrates that a trustee cannot accept part of an unseverable executory contract and reject that portion of no benefit to the estate."). For pertinent portions of the legislative history, see S. REP. NO. 95-989, 95th Cong., 2d Sess. 58-60 (1978), *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5844.

³⁰ *See, e.g., Control Data Corp. v. Zelman*, 602 F.2d 38 (2d Cir. 1979).

³¹ *See In re Lafayette Radio Elec. Corp.*, 8 Bankr. 528, 533 (Bankr. E.D.N.Y. 1981).

³² 11 U.S.C. § 365(b).

³³ *Id.* Note that the provisions of § 365(b) do not apply to "defaults" that are defined, expressly or by implication, in terms of the bankruptcy, insolvency, or financial condition of the debtor. *Id.* § 365(b)(2). This provision is a manifestation of a general Code policy against so-called *ipso facto* contractual clauses that purport to condition particular events on the financial condition of the debtor. *See In re Garnas*, 38 Bankr. 221, 223 (Bankr. D.N.D. 1984) (prohibiting termination of executory insurance contract because of insolvency of insured). *Cf.* 11 U.S.C. § 541(c) (invalidating transfers of property of estate conditioned on financial condition of debtor).

³⁴ 11 U.S.C. § 362(f).

³⁵ *Id.* § 365(c).

single exception to this general rule. Pursuant to section 365(c), the trustee must have the consent of the other party to assume or assign an executory contract if nonbankruptcy law would excuse the other party from rendering performance to or accepting performance from a third party, as in a contract for personal services.³⁶

The ramifications of section 365 for software escrow are obvious. If the court deems the escrow arrangement to be an executory contract as of the time of bankruptcy, the trustee may be able to reject it.³⁷ If the trustee rejects the contract, he will be in a position to reclaim source code in the hands of the user or a third party, denying the user further access to the code.³⁸ Moreover, if the court deems the contract executory, the trustee may have difficulty in assuming it even if inclined to do so; conversely, if the trustee does assume, he may be in a position to make an assignment that is unsatisfactory to the user.³⁹

The critical question, of course, is whether the court will deem the escrow arrangement to be an executory contract. The Code provides no definition of the term. Many courts have adopted the definition proposed by Professor Vern Countryman in an influential 1973 article: "a contract under which the obligation of both the bankrupt

³⁶ See, e.g., *In re Harms*, 10 Bankr. 817, 821 (Bankr. D. Colo. 1981) (limited partnership is personal contract under Colorado law and thus within § 365(c) exception). As a practical matter, courts are often reluctant to find that a contract is within the section even when the nonbankrupt party logically can argue that it was relying on the skill and expertise of the bankrupt party. See, e.g., *In re Varisco*, 16 Bankr. 634, 638 (Bankr. M.D. Fla. 1981) (franchise agreement assumable because not "merely a personal service contract based on special trust and a special relationship of the parties").

³⁷ 11 U.S.C. § 365(a). As should be obvious, the underlying license pursuant to which the user has been furnished the object code is in similar jeopardy. In fact, each of the theories available to attack a source code escrow arrangement is equally applicable to the object code license. If this license is successfully rejected by the trustee, the entire source code escrow question will be moot, because the user will have no need to update software that it no longer can use. For practical suggestions for improving the prospects for survival of both the object code license and the source code escrow in the event of the proprietor's bankruptcy, see *infra* text accompanying notes 96-106.

³⁸ If the escrow agreement is successfully rejected, the user will have no further rights in the escrowed code, and it will revert to the trustee as property of the estate. See *infra* notes 53-80 and accompanying text.

³⁹ See 11 U.S.C. § 365(b) (trustee may not assume executory contract in default without cure and adequate future assurances); § 365(f) (trustee has broad rights to assign executory contracts notwithstanding nonassignment provisions). The trustee's power of assignment does not apply to contracts covered by § 365(c). See *id.* § 365(f); *supra* note 36.

As a practical matter, in a reorganization proceeding under chapter 11 of the Bankruptcy Code, 11 U.S.C. §§ 1101-1120, it is likely to be in the debtor's interest to keep license agreements and related escrows in place, if § 365(c) can be satisfied. In a liquidation under Chapter 7 of the Code, 11 U.S.C. §§ 701-766, however, the trustee's primary concern will be to maximize the present value of the property of the estate, including intellectual property. To the extent that source code is allowed to remain in the hands of third parties, the value of software being sold in connection with the liquidation may be reduced. A software licensor's trustee who is liquidating the licensor's estate will therefore have an incentive to reject outstanding licenses and reclaim any source code in the possession of third parties.

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."⁴⁰ Courts purporting to follow Countryman's bilateral obligation test have reached results that sometimes seem to exalt form over substance. Courts have held, for example, that an exclusive technology license is executory because of the ongoing duty of the licensor to forebear from licensing to others,⁴¹ but that a nonexclusive license is not executory, because of the absence of any such continuing obligation on the part of the licensor.⁴² Similarly, a court has also held that an option on real estate given by the debtors is executory because of the optionors' continuing duty to forebear from selling to others.⁴³

Other courts have adopted other standards, leading to further confusion on the question of the definition of an executory contract. The courts in the Fifth Circuit, for example, have required only that "something remains to be done by one or more of the parties."⁴⁴ Under this standard, courts have held resort time-sharing agreements to be executory.⁴⁵ The Tenth Circuit has required "complex" continuing duties on both sides.⁴⁶ One bankruptcy court has followed this standard, concluding that a limited partnership is executory, even though the limited partners' only further obligation is to furnish money.⁴⁷

If the trustee seeks to reject an escrow arrangement as executory, his success will depend substantially on the court's definition of executory contract. If the court defines the term expansively, the trustee may have to do nothing more than cite the continuing obligations of the nonbankrupt parties (the user and the escrow agent) to comply with the terms of the escrow.⁴⁸ Even if the court applies the bilateral obligation test, the trustee may prevail by demonstrating that the debtor has some minimal continuing duty, such as a duty to update the deposit.⁴⁹

The trustee's apparently broad authority to reject executory contracts, however, must be viewed in light of some important policy

⁴⁰ Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973). See 2 L. KING, COLLIER ON BANKRUPTCY § 365.02 (15th ed. 1980). The legislative history emphasizes the necessity of mutual unfulfilled obligations. See S. REP. NO. 95-989, *supra* note 29, at 58, reprinted in 1978 U.S. CODE CONG. & AD. NEWS 5844.

⁴¹ *In re Select-A-Seat Corp.*, 625 F.2d 290, 292-93 (9th Cir. 1980).

⁴² *In re Richmond Metal Finishers, Inc.*, 38 Bankr. 341 (Bankr. E.D. Va. 1984).

⁴³ *In re Waldron*, 36 Bankr. 633 (Bankr. S.D. Fla. 1984).

⁴⁴ *Ozark-Mahoning Co. v. American Magnesium Co.*, 488 F.2d 147, 152 (5th Cir. 1974).

⁴⁵ *In re Sombrero Reef Club, Inc.*, 18 Bankr. 612, 616-17 (Bankr. S.D. Fla. 1982).

⁴⁶ *Workman v. Harrison*, 282 F.2d 693, 699 (10th Cir. 1960).

⁴⁷ *In re Harms*, 10 Bankr. 817, 820 (Bankr. D. Colo. 1981).

⁴⁸ Such a result might be reached under the Fifth Circuit test, for example. See *supra* notes 44-45 and accompanying text.

⁴⁹ See *supra* notes 41-43 and accompanying text.

considerations. The policy expressed in the statute and the cases is that the trustee should be able to avoid contracts that impose an ongoing and undue burden on the estate.⁵⁰ Rejection is inappropriate, however, where it merely deprives the other party of some fully earned benefit: "Section 365 . . . reflects a number of policies, including not only benefit to the estate but also protection of creditors."⁵¹ Accordingly, if the debtor-proprietor's postbankruptcy duties are minimal, a strong policy argument can be made that protection of the user should be the court's primary concern.⁵²

2. *Property of the Estate*

Section 541(a)(1) of the Code defines "property of the estate" to include "all legal or equitable interests of the debtor in property as of the commencement of the case."⁵³ Pursuant to section 541(c)(1), property of the debtor becomes property of the estate notwithstanding a "spendthrift" provision that purports to restrict transfer of the debtor's interest⁵⁴ or any provision that purports to transfer the property to a third party on the insolvency or bankruptcy of the debtor.⁵⁵ Section 542(a) requires that any entity in possession, custody, or control of property of the estate during the pendency of the bankruptcy case turn it over to the trustee.⁵⁶ Pursuant to section 543, one who has possession of property of the estate as a custodian must take appropriate steps to preserve the property and turn it over to the trustee and account for it.⁵⁷ Finally, section 549 permits the trustee to avoid any transfer of property of the estate that takes place after commencement of the bankruptcy case.⁵⁸

⁵⁰ See, e.g., *Select-A-Seat*, 625 F.2d at 293.

⁵¹ *In re Booth*, 19 Bankr. 53, 55 (Bankr. D. Utah 1982). See also *In re Richmond Metal Finishers, Inc.*, 38 Bankr. 341 (E.D. Va. 1984) (citing equitable considerations in finding that technology license not an executory contract); *In re Petur U.S.A. Instrument Co.*, 35 Bankr. 561 (Bankr. W.D. Wash. 1983) (technology license is executory, but cannot be rejected because of disproportionate harm to nonbankrupt licensee). In the license area, the policy established under § 70b of the former Bankruptcy Act (the predecessor to present § 365) was that licenses could not be rejected even if there were continuing obligations on both sides, "probably because of a 'judicially created policy of protection and encouragement of creative genius.'" *In re Booth*, 19 Bankr. at 57 n.6 (citations omitted).

⁵² See *infra* text accompanying notes 96-106 for drafting suggestions to limit the obligations of the debtor-proprietor and thereby enhance the prospects for enforcement of the escrow arrangement.

⁵³ 11 U.S.C. § 541(a). Property of the estate includes property "wherever located and by whomever held." *Id.*

⁵⁴ *Id.* § 541(c)(1)(A).

⁵⁵ *Id.* § 541(c)(1)(B).

⁵⁶ *Id.* § 542(a).

⁵⁷ *Id.* § 543(a) (custodian with knowledge of commencement of bankruptcy case can take only such action with respect to estate property as is necessary to preserve it); § 543(b) (custodian shall deliver estate property to trustee and file accounting).

⁵⁸ *Id.* § 549(a). Pursuant to § 549(b), in an involuntary bankruptcy, a transfer occurring after the commencement of the case is valid to the extent of any new consideration given. Section 549(c) precludes the trustee from avoiding transfers of real estate made for fair value to certain categories of good faith purchasers.

These provisions have several obvious ramifications on software escrow. If the escrowed source code is property of the estate, the trustee can demand its return and can prevent any subsequent transfer.⁵⁹ Additionally, if the escrowed code is the property of the debtor-proprietor prior to bankruptcy, any contractual provision that purports to transfer it to a third party upon the proprietor's insolvency or bankruptcy probably will be void. The critical issue, therefore, is whether the escrowed code constitutes property of the estate.⁶⁰

Many of the cases decided under section 541 reflect an effort to balance two competing policies: maximizing the value of the estate, while dealing fairly with creditors. A number of cases that have placed greater weight on the former factor have treated property in which the debtor has any interest, however attenuated, as property of the estate.⁶¹ For example, courts have held that progress payments due to a bankrupt contractor are property of the estate notwithstanding a claim made by the contractor's surety,⁶² and that a surplus realized in a prebankruptcy foreclosure sale of the debtor's property is property of the estate, even though a lien on the surplus existed prior to bankruptcy.⁶³ Other courts have emphasized the general principle that the trustee's title "is acquired subject to the equities of third persons, and where it appears that the debtor is only a trustee and has no beneficial interest in or claim against the property, the property will be turned over to the true owner."⁶⁴ Courts emphasizing the rights of third parties have held that a real estate broker's commission in which the seller-debtors had no remaining interest are not included in the property of the estate⁶⁵ and that the

⁵⁹ It has been widely recognized that intellectual property may constitute estate property for bankruptcy purposes. See R. MILGRIM, *TRADE SECRETS* § 1.07 (1982). Accordingly, if escrowed source code were found to be property of the estate, the bankruptcy court's jurisdiction would extend both to the physical property represented by the medium bearing the code (tape, disk, etc.) and the intellectual property embodied in the code.

⁶⁰ The existence of the requisite property interest is determined according to nonbankruptcy law. See *In re Newcomb*, 744 F.2d 621, 625-26 (8th Cir. 1984) (reference to Missouri property law).

⁶¹ This expansive view of the definition of estate property is perhaps best articulated in *In re Brown*, 22 Bankr. 844, 848-49 (Bankr. N.D.N.Y. 1982).

⁶² *In re Glover Constr. Co.*, 30 Bankr. 873 (Bankr. W.D. Ky. 1983).

⁶³ *Brown*, 22 Bankr. at 849-50.

⁶⁴ *In re Georgian Villa*, 10 Bankr. 79, 83-84 (Bankr. N.D. Ga. 1981). See also *George v. Kitchens By Rice Bros.*, 665 F.2d 7 (1st Cir. 1981) (property held by debtors as trustees is not property of estate); *In re Shepard*, 29 Bankr. 928, 932 (Bankr. M.D. Fla. 1983) ("Under the Bankruptcy Code, where a debtor holds only bare legal title to property without any equitable interest, bare legal title is all that becomes property of the estate . . . a trustee in bankruptcy succeeds to only such title and rights in property as the debtor had at the time the petition was filed."); 4 L. KING, *COLLIER ON BANKRUPTCY* § 541.01 (15th ed. 1983).

⁶⁵ *Strafford Sav. Bank v. Bruce*, 122 N.H. 557, 560, 448 A.2d 373, 375 (1982) (in state court litigation parallel to bankruptcy proceeding, held that seller-debtors "had no equitable interest in real estate broker's commission and it should have been excluded from their bankruptcy estate").

estate has no property interest in a lease or other contract that has terminated by its own terms⁶⁶ or because of a default by the debtor⁶⁷ prior to the commencement of the bankruptcy case.

The pragmatic approach often taken in an effort to reconcile these policies is reflected in a series of cases dealing with financial escrows. For example, in *Carlson v. Farmers Home Administration (In re Newcomb)*⁶⁸ the federal government obtained a judgment against the debtor prior to bankruptcy. The debtor placed money satisfying the judgment in escrow pursuant to an agreement of the parties, to be paid to the government if the court of appeals affirmed the judgment. Soon after the court of appeals affirmed the judgment, but before the government was paid the escrowed funds, the debtor filed bankruptcy and the trustee brought an action in the bankruptcy court⁶⁹ to recover the money.

The bankruptcy court found for the trustee, but the Eighth Circuit reversed. One of the issues addressed on appeal was whether payment of the escrowed funds to the government would constitute a postbankruptcy transfer of estate property in violation of section 549.⁷⁰ Looking to nonbankruptcy law, the court of appeals asked whether in fact there would be a transfer of a substantial property interest of the debtor: "we look to the real substance of the interests transferred, not to whether those interests are referred to as 'legal title' or 'equitable interest.'" ⁷¹ Finding that the debtor had transferred the property at the time he created the escrow as a matter of "real substance," the court denied the trustee's claim.⁷²

The court in *Wilson v. Chicago Title Insurance Co. (In re D. Jay Hyman Construction Co.)* reached a similar result.⁷³ In that case, prior to the bankruptcy, the debtor placed money in escrow as a condition to obtaining title insurance. The escrow agent was supposed to release the funds to a construction company that had claim against the debtor if the company obtained a judgment. The company obtained judgment prior to the commencement of the bankruptcy. The court rejected the trustee's effort to recover the escrowed funds on the

⁶⁶ *In re Advent Corp.*, 24 Bankr. 612, 614 (Bankr. App. 1st Cir. 1982) ("The Bankruptcy Code neither enlarges the rights of a debtor under a contract, a Customs bond, nor prevents the termination of a contract by its own terms."). Cf. 11 U.S.C. § 541(b)(2), as amended by Pub. L. No. 98-353, § 363(a), 98 Stat. 333, 363 (1984) ("Property of the estate does not include . . . any interest of the debtor as a lessee under a lease of nonresidential real property that has terminated . . . before the commencement of the case").

⁶⁷ *In re Depoy*, 29 Bankr. 466 (Bankr. N.D. Ind. 1983) (where debtors in material default under lease prior to filing of bankruptcy, termination and eviction will not be stayed).

⁶⁸ 744 F.2d 621 (8th Cir. 1984).

⁶⁹ *In re Newcomb*, 32 Bankr. 96 (Bankr. W.D. Mo. 1983).

⁷⁰ 744 F.2d at 624-25. See *supra* note 58 and accompanying text.

⁷¹ *Id.* at 626.

⁷² *Id.* at 626-27.

⁷³ 15 Bankr. 765 (Bankr. D. Md. 1981).

ground that any real interest of the debtor had been extinguished at the time the judgment was rendered.⁷⁴

The court in *Heckler Land Development Corp. v. Township of Montgomery (In re Heckler Land Development Corp.)*⁷⁵ reached a different result. Prior to bankruptcy, the debtor had begun a construction project for the town and had established an escrow account to secure its performance. When the debtor filed for bankruptcy before it had completed the project, the town sought to recover the escrowed funds. The bankruptcy court rejected the claim, finding that the town was merely a creditor trying to collect a prebankruptcy indebtedness.⁷⁶ Although the opinion is cryptic, the factor that distinguishes the case from *Hyman Construction* and *Newcomb* is probably the relative lack of certainty in the third party's claim against the escrowed funds. Since neither the validity nor the amount of the town's claim was beyond dispute, the estate's interest in the fund, while not absolute, did amount to a matter of "real substance."⁷⁷

The foregoing cases suggest that a court required to decide whether escrowed source code constitutes property of the estate will examine the substantiality of the debtor-proprietor's interest in the code since the commencement of the bankruptcy case. If that interest is substantial, the court may permit the trustee to recover the code.⁷⁸ Moreover, a provision in the escrow agreement that purports to transfer all interest in the code to the user or escrow agent upon the occurrence of a contingency defined in terms of the financial condition of the proprietor will be void.⁷⁹ The goal in drafting the escrow, therefore, must be to minimize the proprietor's interest in the escrowed materials and the intellectual property that they embody, either initially or upon the occurrence of a contingency that the agreement defines in nonfinancial terms and is likely to precede bankruptcy, without jeopardizing the proprietor's intellectual property protection.⁸⁰ The drafter must take advantage of the policy

⁷⁴ *Id.* at 767.

⁷⁵ 15 Bankr. 856 (Bankr. E.D. Pa. 1981).

⁷⁶ *Id.* at 858-59.

⁷⁷ *Newcomb*, 744 F.2d at 626.

⁷⁸ As discussed in note 39 *supra*, the trustee is more likely to have an incentive to recover the code in a liquidation proceeding than in a reorganization proceeding.

A further illustration of the problem of defining property of the estate is the question whether a bank's payment of a letter of credit that guarantees an obligation of the debtor constitutes distribution of estate property. Payment has been allowed on the theory that the property of the bank is being distributed, with no new obligation on the debtor's part being created; payment has been forbidden where it would give rise to a security interest against the debtor in favor of the bank. Compare *In re North Shore & Cent. Ill. Freight Co.*, 30 Bankr. 377 (Bankr. N.D. Ill. 1983) and *In re Page*, 18 Bankr. 713 (Bankr. D.D.C. 1982) (payment allowed), with *In re Twist Cap Inc.*, 1 Bankr. 284 (Bankr. M.D. Fla. 1979) (payment stayed). See generally Baird, *Standby Letters of Credit in Bankruptcy*, 49 U. CHI. L. REV. 130 (1982).

⁷⁹ See *supra* note 55 and accompanying text.

⁸⁰ See *infra* text accompanying notes 96-106.

favoring vulnerable third parties when, in a pragmatic sense, the debtor is not the true owner of the property.⁸¹

3. Automatic Stay

A final set of questions arises under the automatic stay provisions of section 362 of the Code.⁸² Pursuant to section 362(a), the filing of a bankruptcy petition operates as an automatic stay of any judicial action against the debtor,⁸³ any act to obtain possession of or control over property of the estate,⁸⁴ and any act to create, perfect, or enforce a lien against property of the estate.⁸⁵ The violator may be in contempt of court for any violation of the automatic stay.⁸⁶ Pursuant to section 362(c), the stay continues until the affected property is no longer part of the estate.⁸⁷

Sections 362(d)-(f) provide a procedure for an aggrieved party to seek relief from the stay. After notice and hearing, the bankruptcy court "shall grant relief" to an aggrieved party who can demonstrate that its interest is not adequately protected, or that the debtor does not have "an equity" in the affected property and the property is not necessary to an effective reorganization.⁸⁸ If the Court does not hold a hearing within thirty days of a request for relief, the stay terminates.⁸⁹ The court also has the power to grant *ex parte* relief from the stay if the affected party would otherwise suffer irreparable harm to its interests.⁹⁰

In the source code escrow context, the automatic stay provision may be an important means of enforcing the rules relating to property of the estate. If the escrowed code is property of the estate, the provision will stay any effort to take possession of it by or on behalf of the user. The stay prohibits both judicial and self-help efforts. Thus, if the code is property of the estate, even if it is in the hands of the escrow agent at the time of bankruptcy, any attempt by the user to retrieve it may run afoul of the stay and create a risk of contempt.

The policy behind section 362 and its Bankruptcy Act predecessor,⁹¹ however, is similar to the policy underlying section 541: the debtor should be protected from creditor harassment, but not at the expense of innocent third parties.⁹² This policy is illustrated by a

⁸¹ See *id.* for specific suggestions for achieving this delicate balance.

⁸² 11 U.S.C. § 362.

⁸³ *Id.* § 362(a)(1).

⁸⁴ *Id.* § 362(a)(3).

⁸⁵ *Id.* § 362(a)(5).

⁸⁶ See, e.g., *In re Holland*, 21 Bankr. 681, 689 (Bankr. N.D. Ind. 1982).

⁸⁷ 11 U.S.C. § 362(c)(1).

⁸⁸ *Id.* § 362(d).

⁸⁹ *Id.* § 362(e).

⁹⁰ *Id.* § 362(f).

⁹¹ Bankruptcy Act of 1898, *supra* note 29, at § 29.

⁹² See, e.g., *Schulze v. Schulze*, 15 Bankr. 106, 109 (Bankr. S.D. Ohio 1981) (citing

line of authority holding that the debtor should not use the stay to deprive third parties of the benefits of acts that have been completed prior to the filing of bankruptcy.⁹³ If, for example, a lease or license lawfully terminates prior to bankruptcy, but bankruptcy occurs before the termination is effective, section 362 will not stay the termination if at the time of bankruptcy "nothing remained to complete the termination process, except the mere passage of time."⁹⁴

This policy and the decisions based on it are relevant to source code escrow in two important respects. Generally, a user who is dependent on the debtor's software should be able to argue persuasively that denial of access to the source code via the stay would contravene the purposes of section 362.⁹⁵ More specifically, the authority just discussed suggests that a user may avoid the effects of the stay if the agreement conditions the turnover of source code to the user on some nonfinancial event likely to occur prior to bankruptcy (such as an explicit measure of failure to maintain), so that the turnover process can be substantially completed before the bankruptcy petition is filed.

C. Drafting Recommendations

There is no simple, foolproof solution to the problem of drafting source code escrow agreements that will be enforceable in bankruptcy. The drafting process involves striking a balance between the proprietor's trade secret concerns and the user's desire to have as much of the transaction as possible consummated before a bankruptcy proceeding begins. The point at which the balance is struck in a particular transaction will depend on the relative bargaining positions of the parties and how seriously each side views its potential problems.⁹⁶ Because a workable escrow arrangement requires con-

policy under current Code, court declines to stay domestic proceeding against debtor); Preferred Surfacing, Inc. v. Gwinnett Bank & Trust Co., 400 F. Supp. 280, 284 (N.D. Ga. 1975) (discussion of policy under former Act). Note also that sections 362(d)-(f), which provide a variety of remedies for parties aggrieved by a stay, strongly imply that the stay should not be used to impose unfair burdens on innocent third parties.

⁹³ See, e.g., *In re Depoy*, 29 Bankr. 466, 470 (Bankr. N.D. Ind. 1983) (eviction of debtor and recovery of leased premises by landlord will not be stayed where lease has terminated prior to bankruptcy because of debtor's default); *In re Beck*, 5 Bankr. 169, 170 (Bankr. D. Hawaii 1980) (court refuses to stay termination of license where notice given prior to bankruptcy, to take effect after bankruptcy proceeding commenced). The *Depoy-Beck* result has been codified with respect to leases of nonresidential real estate in current § 541(b)(2). See *supra* note 66.

⁹⁴ *Beck*, 5 Bankr. at 170.

⁹⁵ As part of a larger case that escrowed source code should not be treated as property of the estate, a user who is dependent on the debtor's software can argue that denial of access to the code via the stay would victimize an innocent third party who is not engaged in the sort of creditor harassment that § 362 was intended to prevent.

⁹⁶ To cite an extreme example, a user of well-tested, mass-marketed software will not be in a position to demand that a vendor establish an enforceable escrow for its protection. Where the vendor produces a relatively small number of high-priced, custom designed

siderable compromise on both sides, a party seeking to tip the balance markedly in its favor should be prepared to pay for the extraordinary concessions that the other side may have to make.⁹⁷

As previously noted,⁹⁸ each of the theories available to attack an escrow arrangement is equally applicable to the license that provided the user with object code. Obviously, if the object code license terminates after the proprietor's bankruptcy, the user has no further right to use the software in any way, and the availability of source code for maintenance and update purposes is a moot issue. Accordingly, the user faces a continuum of risk, from the worst case in which the trustee terminates the underlying object code license, through the middle ground in which the user retains the right to use code escrowed through the date of bankruptcy, to the best case in which the user both retains delivered code and continues to receive updated code from a debtor-proprietor that remains in business. The recommendations offered here are made from the viewpoint of the user. They are cumulative, and a court's rejection of any particular provision results in only a single step backward along the continuum of risk.

1. *General Recommendations*

a. *Multiple Contracts*

The Bankruptcy Code may permit a trustee to reject an entire agreement even if only a portion is still executory.⁹⁹ Thus, the trustee of a proprietor who has escrowed a series of source code updates may be in a position not only to avoid future maintenance obligations, but also to demand the return of past updates. To minimize this risk, the user should seek multiple contracts so that a trustee can not recall completed deliveries as a portion of a single executory contract. For example, the parties may divide the overall agreement into an object code license, a source code agreement, and a maintenance agreement. Each contract should have a separately negotiated bona fide consideration. Similarly, the user should avoid unitary long-term contracts; the National Football League model of a series of short-term contracts is preferable.

software packages, however, each transaction may be of such significance that it will be willing to assume some small risk to its intellectual property protection to meet a prospective user's demands.

⁹⁷ The authors frequently remind clients that in acquiring a computer system, a customer is purchasing not only a product but also a relationship. Just as the customer would be willing to pay a higher price for a superior product, he or she should be open to the possibility of paying somewhat more to improve the quality of the relationship.

⁹⁸ See *supra* note 37.

⁹⁹ See *supra* note 29 and accompanying text.

b. Minimizing Future Obligations

The user should avoid including in the underlying object code license any future obligations of the proprietor (maintenance, for example) that are not essential to the current use of the software. Any such future obligations should be in an agreement separate from the underlying license.

c. Present Grant of Rights

The user should avoid any agreement that purports to obligate the proprietor to grant rights in the source code only upon the occurrence of a future event, particularly if that event is tied to the financial condition of the proprietor. The user should insist that the proprietor grant either it or the escrow agent present, but suitably restricted, rights in the source code.

d. Rights in Physical Property

In the event of the proprietor's bankruptcy, the user may have to return any source code that is "property of the estate."¹⁰⁰ To minimize this problem, the user should seek to avoid the retention by the proprietor of substantial physical property rights in the copy of the source code deposited in escrow. From the user's perspective, it would be preferable for the proprietor to assign the copy of the source code to either the user or the escrow agent. Of course, a proprietor seeking to maintain trade secret protection probably would object to this agreement. Alternatively, the user might obtain a present, but limited, license to the source code, that makes a present grant of contingent future rights of access and use.¹⁰¹ In either case, the proprietor should have no right to require the return of the user's copy of the source code; rather, the agreement should obligate the escrow agent or user to destroy the copy, or simply to hold it in confidence until it is outdated and no longer of any value.

e. Status of Escrow Agent

To minimize the probability that a court will deem the escrowed code property of the estate, the agreement should clearly define the status of the escrow agent as either an independent contractor or an agent of the user. The escrow agent should never be a mere custodian of the source code or an agent or bailee of the proprietor. The contract should obligate the escrow agent to the proprietor to maintain the confidentiality of the source code.

¹⁰⁰ 11 U.S.C. § 541(a). See *supra* notes 53-60 and accompanying text.

¹⁰¹ For example, the agreement may make a present grant to the user of the right to use the source code, but provide further that the code may be examined only by the escrowee as agent of the user unless and until a carefully defined maintenance failure occurs.

f. Maintenance by Escrow Agent

The proprietor may resist any agreement that results in the transfer or disclosure of source code to the user absent its bankruptcy or a judicial (and thus time-consuming) determination of inadequate maintenance. Accordingly, the user should consider an agreement that does not require or permit the escrow agent to transfer source code to the user, but instead permits the escrow agent to use the source code to maintain the user's object code. When entering such an agreement, the parties must choose an agent who has the capability to use the escrowed source code to maintain the program.

g. Definition of Default

The user should avoid any agreement that conditions the transfer of the source code from proprietor to escrow agent or from escrow agent to user upon any default defined in terms of the financial condition of the proprietor.¹⁰² The user should seek to define default in terms of inadequate maintenance by the proprietor and to have any transfer to the user completed prior to the bankruptcy of the proprietor. To avoid the argument that the default clause is a disguised financial condition clause, the user should insist that the agreement contain recitations concerning the importance to the user of adequate performance.

2. Suggested Model

In view of the general considerations just discussed, the authors suggest three separate agreements: an object code license, a source code license, and a maintenance agreement. This model does not include all the terms that are appropriate in licensing or maintenance agreements.¹⁰³ It discusses only those terms that strike the balance between the proprietor's disclosure of proprietary information and the user's ability to enforce the agreement in the event of the proprietor's bankruptcy.

a. Object Code License

This license should contain all the customary provisions of an object code license, but should not include any continuing obligations of the proprietor with respect to maintenance. The license should not require return of the code at its termination, but should require the user to maintain the object code in confidence for some period well in excess of its useful life, as determined by the proprietor, or to certify its destruction.

¹⁰² See *supra* note 55 and accompanying text.

¹⁰³ For a general review of software licensing, see J. SOMA, *COMPUTER TECHNOLOGY AND THE LAW* § 3.13 (1983).

b. *Source Code Agreement*

(i) *Grant of Rights*

This agreement should contain a present grant of limited rights in the source code. In descending order of desirability from the perspective of the user's concern for enforceability in bankruptcy, this grant may be:

- (a) a present assignment to the user of the source code and supporting materials, with the escrow agent retaining physical possession pending the specified contingencies;
- (b) a similar present assignment to the escrow agent;
- (c) a present license to the user to make limited use of the source code upon the happening of specified contingencies, with the escrow agent otherwise retaining physical possession;
- (d) a similar present license to the escrow agent. It is unacceptable for the proprietor merely to contract to grant rights in the source code upon the occurrence of a future event.

(ii) *Restrictions on Disclosure of the Source Code to Third Parties.*

The agreement should contain restrictions on the right of the escrow agent and the user to disclose the source code to third parties. In descending order of likelihood of enforceability in the event of bankruptcy, the restriction may be:

- (a) the obligation not to disclose the source code for a specified term in excess of the proprietor's estimate of its useful life;
- (b) the obligation not to disclose the source code for an unlimited period of time;
- (c) the obligation not to disclose the source code for a specified term together with the obligation to destroy the source code at the end of that term. The agreement should not require the user and escrow agent to return the source code to the proprietor. The agreement may, however, grant the proprietor the right to supervise and verify the destruction of the code.

(iii) *Conditions on Use by or Disclosure to User*

The agreement must provide for the use by or disclosure to the user of the source code under certain conditions. In descending order of likelihood of enforceability in the event of bankruptcy, the provision may be:

- (a) that the escrow agent may not transfer or disclose the source code to the user, but may maintain and update the object code upon request or certification by the user;¹⁰⁴
- (b) that the escrow agent may disclose, but not assign the source code to the user upon the user's request or certification of in-

¹⁰⁴ Software proprietors sometimes insist that the agreement be written to require a judicial or quasi-judicial determination of inadequate maintenance. From the user's perspective, the delay likely to be caused by such a determination may defeat the purpose of the escrow arrangement.

adequate maintenance. The triggering event should never relate to the financial condition of the proprietor.

c. Maintenance Agreement

(i) Term

In bankruptcy, the proprietor can avoid future maintenance obligations as executory. In structuring the maintenance agreement, the user's goal must be to preserve for its benefit as much of the completed maintenance work as possible. The greatest danger here is that upon the rejection of the entire maintenance agreement as a unitary executory contract, the trustee may demand return of all previously completed maintenance work.¹⁰⁵ Accordingly, the form of the agreement should not be a single contract for the ongoing maintenance of the program during the term of the underlying license, but should be a series of contracts for relatively short fixed terms.

(ii) Consideration

There also should be separate consideration due for each term of the maintenance agreement.

(iii) Obligations of Proprietor

The agreement should obligate the proprietor to maintain the program and periodically to deliver updated object code and source code to either the user or the escrow agent. The proprietor should not have any other future obligation unless it is essential to the transaction.

(iv) Status of Code

The agreement should contain a provision for the automatic license to the user of the updated object code without any further action by the proprietor. In addition, the agreement should provide for the automatic grant of rights in the updated source code. This grant should parallel that in the source code agreement.

(v) Restrictions on Foreclosure

The agreement should contain restrictions on the right of the escrow agent and the user to disclose the updated source code to third parties, which should also parallel those in the source code agreement. The agreement should not require the escrow agent to return the source code to the proprietor, but may grant the proprietor the right to supervise and verify the destruction of the code.

¹⁰⁵ See *supra* note 29 and accompanying text.

(vi) *Conditions on User*

The agreement must provide for the use by or disclosure to the user of the updated source code under certain conditions. The terms of use or disclosure should parallel those in the source code agreement. The triggering event should never relate to the financial condition of the proprietor.

(vii) *Status of Escrow Agents*

The agreement specifically should identify the escrow agent as either an agent of the user or an independent contractor. The agreement should never identify the escrow agent as either a mere custodian or an agent or bailee of the proprietor.¹⁰⁶

III. The International Perspective

In international software transactions that involve American proprietors or users, the parties sometimes place source code in escrow outside the United States. A foreign proprietor, for example, may insist on placing the code in escrow in its country because of concerns about trade secret protection. Conversely, a foreign user may insist that the code be kept in its country to facilitate access. In some circumstances, the parties may agree to escrow the code in a third country in the belief that its laws will enhance security and minimize the possibility of governmental interference with the arrangement.¹⁰⁷

Enforceability in the event of the proprietor's bankruptcy is as much a concern in an international escrow arrangement as in a domestic one. A user dealing with a foreign proprietor must consider the potential effect of the bankruptcy law of the country in which it is incorporated or headquartered or has substantial assets. The law of the country of the physical location of the escrowed code also may become relevant.

¹⁰⁶ If the escrow agent is identified as a custodian for the benefit of the proprietor, he or she may be subject to the automatic turnover requirement of § 543 of the Code. See *supra* note 57 and accompanying text. The identification of the escrow agent as a bailee or agent of the proprietor will increase the likelihood that the proprietor will be found to have a substantial property interest in the escrowed code, which in turn may lead to a finding that the code is property of the estate. See *supra* notes 61-77 and accompanying text.

¹⁰⁷ A related issue is the growing trend toward the imposition of some form of control on the transfer of electronically stored data across international boundaries. Such control may range from requiring registration to limiting or prohibiting certain kinds of transactions. The rationales asserted range from protection of privacy to concerns about "technological imperialism." Because an escrow arrangement may contemplate the transfer of electronically stored data across international boundaries, the possibility of applicable restrictions must be considered. For a recent review of this issue, see G. CABANELLAS, *ANTI-TRUST AND DIRECT REGULATION OF INTERNATIONAL TRANSFER OF TECHNOLOGY TRANSACTIONS* (1984).

A. The Scope of the Problem

International law recognizes two major theories of bankruptcy: the territorial theory and the universal theory.¹⁰⁸ Under the territorial theory, the status of the alleged bankrupt must be separately adjudicated in each country in which it has assets. Thus, a determination in one country that a company is bankrupt has no binding effect on assets and claims against assets in another country. Under the universal theory, an adjudication in one country that a company is bankrupt incapacitates that company in all countries in which it does business. While local law may control asset-related questions, such as preferences and the enforcement of security interests, one adjudication will determine the status of the bankrupt. The universal theory requires implementation by international treaty.

Although much effort has been devoted to adoption of the universal theory, the countries of Western Europe have yet to agree on it. The members of the European Economic Community (the Common Market) have considered, but have not yet ratified, a draft convention on bankruptcy which embodies the universal theory.¹⁰⁹ The country in which the debtor's "center of administration" is located has jurisdiction over the bankruptcy,¹¹⁰ including the disposition of assets in other states that are parties to the Convention.¹¹¹ The bankruptcy divests the debtor of his right to administer his assets in any of the participating states. As in American bankruptcy law, the Convention reserves certain matters for determination under local law. These matters include the powers of a liquidator, the status of leases, the determination of the rights of secured parties, and the question of preferences.¹¹²

If adopted, the Convention would greatly simplify the identification of bankrupts and the administration of bankrupts' estates. The present draft of the Convention does not, however, deal explicitly with issues like those covered by sections 541 (property of the estate) and 365 (executory contracts)¹¹³ of the United States Bankruptcy Code. Moreover, the Convention's general policy is to refer ques-

¹⁰⁸ For a discussion of these theories and their recognition among the countries of western Europe, see COMMON MKT. REP. (CCH) § 6101.03. Belgium, for example, recognizes the universal theory, *see id.*; AMERICAN BAR ASS'N, SECTION OF INTERNATIONAL LAW, EUROPEAN BANKRUPTCY LAWS 71 (I. Ross ed. 1974); while France follows the territorial approach, *see id.* at 106, and Italy uses both approaches concurrently. *See id.* at 136-38. The ABA volume provides a useful introduction to the history and general contours of bankruptcy law in the countries of Western Europe.

¹⁰⁹ European Economic Community, Draft of a Convention on Bankruptcy, Winding-Up, Arrangements, Compositions and Similar Proceedings (1980 draft), *reprinted in* COMMON MKT. REP. (CCH) ¶¶ 6111-6221 hereinafter cited as EEC Convention.

¹¹⁰ *Id.* art. 3.

¹¹¹ *Id.* art. 34.

¹¹² *See, e.g., id.* arts. 29, 36, 39, 40, 46.

¹¹³ *But cf. id.* art. 39 (referring questions concerning leases to local law).

tions about the status of particular assets and obligations to local law. Accordingly, it seems likely that even if the European Economic Community ratifies the Convention, local law will continue to decide most questions pertaining to the enforceability of software escrow agreements. In most cases, "local law" will mean the law of the nation where the escrowed property is physical located. However, the law of the bankrupt's headquarters or principal place of business, or the law of the nation where the parties execute the escrow agreement might decide some questions.¹¹⁴ Clearly, the Convention would not obviate the duty to consider the potential effect of the bankruptcy laws of every nation having a substantial relation to the transaction.

B. *Two Case Studies*

Given the current lack of international structure, the lawyer arranging an international escrow agreement has no choice but to consider the potential effect of the bankruptcy laws of the nation where the escrowed property is to be located, as well as of the nations where the foreign principals are located. This section discusses specifically some of the problems that a lawyer may encounter in structuring an arrangement where a proprietor in Great Britain or the Federal Republic of Germany (West Germany) establishes a software escrow in its own country for the benefit of an American user. The problems a lawyer faces in these two countries are typical of those encountered in a number of other western European nations.¹¹⁵ Most of these problems are analogous to issues that arise under the American Bankruptcy Code.

1. *Great Britain*

Several English statutes deal with bankruptcy-related issues. Two of the most important of these are the Bankruptcy Act of 1914¹¹⁶ and the Companies Act of 1948,¹¹⁷ which deals with the "winding up" of companies for a variety of reasons, including insol-

¹¹⁴ Pursuant to article 36 of the EEC Convention, for example, issues concerning preferences are resolved under the law of the state where the affected assets are located at the time the proceeding is commenced. Similarly, article 39, which deals with leases of "immovable property," and article 40, which deals with contracts for the sale of such property, refer to the law of the state where the property is located. These provisions suggest a general tendency to refer all questions concerning the status of property to the law of the jurisdiction where it is physically located. In the absence of any provisions that deal expressly with the status of intellectual property or with arrangements in the nature of escrows, however, it would seem imprudent to ignore other arguably relevant bodies of local law.

¹¹⁵ See generally AMERICAN BAR ASS'N, *supra* note 108.

¹¹⁶ Bankruptcy Act, 1914, 4 & 5 Geo. 5, ch. 59, as amended [hereinafter cited as Bankruptcy Act].

¹¹⁷ Companies Act, 1948, 11 & 12 Geo. 6, ch. 38, as amended [hereinafter cited as Companies Act].

vency. The following material discusses provisions of these two statutes that are particularly relevant to source code escrow.

Section 53 of the Bankruptcy Act provides that upon commencement of the bankruptcy, the property of the debtor vests immediately in the trustee.¹¹⁸ Pursuant to section 48, the property of the debtor includes all forms of property, whether tangible or intangible.¹¹⁹ The Act does not specify the level of interest required to characterize an asset as "property of the debtor."

Section 54(1) of the Bankruptcy Act permits the trustee to disclaim property that consists of "unprofitable contracts."¹²⁰ This provision is analogous to the American trustee's right to reject burdensome executory contracts.

Sections 243 and 244 of the Companies Act empower the liquidator of a company to "take into his custody or under his control all the property and things in action to which the company is or appears to be entitled."¹²¹ The Act does not otherwise define the relevant property. Upon application to the supervising court by the liquidation and entry of an appropriate order, "property of whatsoever description belonging to the company or held by trustees on its behalf shall vest in the liquidator by his official name."¹²²

The Companies Act contains other provisions relevant to source code escrow. Section 268 provides the court supervising the wind-

¹¹⁸ Bankruptcy Act, § 53(1) ("immediately on a debtor being adjudged bankrupt, the property of the bankrupt shall vest in the trustee"), (2) ("On the appointment of a trustee, the property shall forthwith pass to and vest in the trustee appointed."). Adjudication of bankruptcy is accomplished by resolution of the creditors or court order. *Id.* See also *id.* § 18(1).

¹¹⁹ *Id.* § 48. Section 48, which is entitled "Realisation of Property," gives directions to the trustee for taking possession of many kinds of property, including "deeds, books, and documents of the bankrupt, and all other parts of his property capable of manual delivery," *id.* § 48(1); "stocks, shares in ships, shares, or any other property transferable in the books of any company, office, or person," *id.* § 48(3); "property . . . of copyhold or customary tenure, or . . . any like property passing by surrender or admittance or in any similar manner," *id.* § 48(4); and "things in action," *id.* § 48(5).

¹²⁰ *Id.* § 54(1). The categories of property that may be disclaimed include "land of any tenure burdened with onerous covenants, . . . shares of stock in companies, . . . unprofitable contracts, or . . . any other property that is unsaleable, or not readily saleable, by reason of it binding the possessor thereof to any onerous act, or to the payment of any sum of money . . ." The disclaimer operates to divest the bankrupt of all interest in the property disclaimed. *Id.* § 54(2). The trustee may not disclaim a lease without leave of court. *Id.* § 54(3). A party interested in particular property may call upon the trustee in writing to make a decision concerning disclaimer, and a party with an interest in a contract may similarly call upon the trustee to disclaim or adopt it. *Id.* § 54(4). The court may rescind contracts between the bankrupt and other parties, awarding damages or other relief to the affected party, *id.* § 54(5), and may also order the vesting of disclaimed property in third parties "on such terms as the court thinks just." *Id.* § 54(6).

¹²¹ Companies Act, § 243(1).

¹²² *Id.* § 244. The liquidator may thereafter "bring in his official name any action or other legal proceeding which relates to that property or which it is necessary to bring or defend for the purpose of effectually winding up the company and recovering its property." *Id.*

ing up of a company with broad powers to summon for examination any person suspected of holding company property or of having information concerning company property.¹²³ Section 323(1), which resembles section 54(1) of the Bankruptcy Act, permits a company's liquidator to disclaim "unprofitable contracts."¹²⁴ Section 328 provides that it is a criminal offense for an officer of the bankrupt company to fail to "discover" and "deliver up" to the liquidator all company property.¹²⁵

These statutory provisions suggest possible problems analogous to the "property of the estate" and "executory contract" problems encountered under the American Bankruptcy Code. However, the reported cases and secondary sources generally available to American lawyers provide even less guidance than the American sources on the application of the statutes in the source code escrow context.¹²⁶

2. Federal Republic of Germany

West German law recognizes two principal types of insolvency proceedings: bankruptcy and court or mandatory composition.¹²⁷ The precondition for either type of proceeding is an inability to meet obligations in due course, or the inability of a corporation to meet obligations in excess of assets.¹²⁸ Creditors generally initiate bankruptcy proceedings, which usually result in liquidation.¹²⁹ Only the debtor can initiate mandatory composition proceedings.¹³⁰ During the pendency of a composition proceeding, the debtor remains in

¹²³ *Id.* § 268(1). The court may summon "any officer of the company or person known or suspected to have in his possession any property of the company . . . or any person whom the court deems capable of giving information concerning the . . . affairs or property of the company." *Id.* Such persons may be examined under oath, *id.* § 268(2), and compelled to produce documents, *id.* § 268(3), and are subject to arrest if they fail to appear. *Id.* § 268(4).

¹²⁴ *Id.* § 323(1). The provisions of § 323 are virtually identical to those of § 541 of the Bankruptcy Act. See *supra* note 120.

¹²⁵ *Id.* § 328(1).

¹²⁶ Annotations of decisions under the Bankruptcy and Companies Acts may be found in 3 & 5 HALSBURY'S STATUTES OF ENGLAND (3d ed. 1968, with Cont'n Vols.). General discussions of English bankruptcy law that are widely available in American law libraries include Bateson & Grant, *The Commercial Law of England* (1983), in 4 DIGEST OF COMMERCIAL LAWS OF THE WORLD (L. Nelson ed. 1984); AMERICAN BAR ASS'N, *supra* note 108, at 75-85.

¹²⁷ See M. PELZER, GERMAN INSOLVENCY LAWS 1-2, 15 (1975). This volume provides a German text of the West German insolvency laws as well as a section-by-section English translation and commentary. Before reliance is placed on the translation of a particular section, that section can be checked for recent amendment in the official West Germany statutory sources. See *infra* notes 134-35. General discussion of West German insolvency law may be found in AMERICAN BAR ASS'N, *supra* note 108, at 121-32; Esser, Ruster & Zahn, *The Commercial Law of the Federal Republic of Germany and West Berlin* (1980), in 4 DIGEST OF COMMERCIAL LAWS OF THE WORLD (L. Nelson ed. 1984).

¹²⁸ M. PELZER, *supra* note 127, at 12, 15.

¹²⁹ *Id.* at 1-3.

¹³⁰ *Id.* at 15.

possession and control of his assets, subject to court supervision.¹³¹ The result of a successful composition is a plan that the court and a majority of creditors must approve and that will be binding on dissenting creditors.¹³² Even when creditors have initiated bankruptcy proceedings, the debtor can apply to the court to suspend those proceedings and commence a composition.¹³³

The Bankruptcy Act, or *Konkursordnung* of 1877, often referred to as the KO,¹³⁴ sets forth the substantive and procedural law of bankruptcy. The Act on Court Compositions, or *Vergleichsordnung* of 1935, often referred to as the VerglO,¹³⁵ governs compositions. Several provisions of each statute are relevant to source code escrow.

Section 117 of the KO requires the receiver to take immediate custody of all property of the bankrupt.¹³⁶ The KO does not otherwise define the relevant properties. The public announcement of the proceedings effects an immediate attachment of all the bankrupt's property.¹³⁷ Section 118 enjoins all persons having possession of such property from returning it to the bankrupt or otherwise using it for the bankrupt's benefit¹³⁸ and requires them to notify the receiver¹³⁹ and produce the property on demand.¹⁴⁰ Persons holding estate property who fail to notify the receiver are liable for actual damages.¹⁴¹ The effect of these provisions appears to be similar to that of the provisions dealing with the property of the estate and stays in American bankruptcy law, because they identify and freeze estate property upon the filing of bankruptcy.

Section 17 of the KO deals with bilateral contracts, defined only as contracts imposing mutually dependent obligations.¹⁴² When the contract is wholly or partially unperformed at the commencement of bankruptcy proceedings, the receiver may perform on behalf of the bankrupt and demand performance from the nonbankrupt party.¹⁴³ The KO does not address the complementary question whether the nonbankrupt party may demand performance from the receiver.

¹³¹ *Id.* at 18-19.

¹³² *Id.* at 19-21.

¹³³ *Id.* at 15.

¹³⁴ *Konkursordnung vom 1877*, as amended, RGB1.S.351 [hereinafter cited as KO], translated in M. PELZER, *supra* note 127, at 26-130.

¹³⁵ *Vergleichsordnung vom 1935*, as amended, RGB1.I.S.321, ber.S.356 [hereinafter cited as VerglO], translated in M. PELZER, *supra* note 127, at 131-206.

¹³⁶ KO, § 117(1).

¹³⁷ *Id.* § 118.

¹³⁸ *Id.*

¹³⁹ *Id.*

¹⁴⁰ *Id.* § 120.

¹⁴¹ *Id.* § 119.

¹⁴² *Id.* § 17. The definition appears in the heading of the section. Pelzer translates the definition of "contracts where performance and considerations sic. are dependent of sic. each other." M. PELZER, *supra* note 127, at 34.

¹⁴³ KO, § 17(1). To insist on performance, the receiver must give the other party prompt notice of his intention to do so. *Id.* § 17(2).

Given the broad powers of the receiver and the limitations on the rights of third parties expressed elsewhere in the KO,¹⁴⁴ the prudent operating assumption is probably that a court will answer this question in the negative.

Section 21 of the KO comes closer than any other to dealing with licenses. It provides that a lease or rental contract remains valid against the estate when the leased item is already in the possession of a nonbankrupt lessee.¹⁴⁵ One might argue that this section evinces a policy in favor of protecting innocent lessees and, by analogy, licensees against arbitrary and potentially damaging dispossession.

Section 237 of the KO permits execution of foreign bankruptcy judgments against assets located in Germany.¹⁴⁶ This ability is subject to any exceptions that the Chancellor may create.

Sections 36 and 50 of the VerglO deal with the status of contracts during composition proceedings. Section 36 deals with contract claims against the estate. A creditor who has not fully performed at the commencement of the composition proceedings has no claim.¹⁴⁷ If the contract is divisible, however, the creditor may make a claim for the value of completed installments.¹⁴⁸ Section 36 is also further evidence of a general policy of favoring the estate in contract matters even at the expense of the interest of the nonbankrupt party.

Pursuant to section 50(1), a creditor may refuse to perform its obligations under a contract with the debtor, if both parties had further obligations at the commencement of the proceedings.¹⁴⁹ This refusal requires court approval.¹⁵⁰ The VErglO, like the KO, does not address the question of the debtor's right to refuse to perform. Again, the prudent assumption is that the creditor cannot compel the debtor to perform.

Sections 58 through 60, 62, and 63 of the VerglO are also relevant to source code escrow. The court may impose restrictions on the disposal of assets by the composition debtor, on its own motion

¹⁴⁴ Note, for example, the limits on the rights of third parties to deal with estate property and the receiver's authority to reclaim estate property from such parties. *See supra* notes 136-41 and accompanying text. The statute also limits the ability of creditors to pursue legal remedies against the debtor and the estate once the bankruptcy proceeding has begun. *See* KO, §§ 11-15.

¹⁴⁵ *Id.* § 21(1). Section 21(3) gives a lessee of the bankrupt the right to set off any claim he may have against rent due to the estate.

¹⁴⁶ *Id.* § 237(1)-(2). This section could permit a trustee acting under the authority of another nation's bankruptcy courts to attempt to reclaim, as an asset of the debtor, source code that had been escrowed in West Germany.

¹⁴⁷ VerglO, § 36(1).

¹⁴⁸ *Id.* § 36(2).

¹⁴⁹ *Id.* § 50(1). In the case of a divisible contract, the nondebtor party must elect between withdrawal and pursuing a claim for completed installments under § 36(2). *Id.*

¹⁵⁰ *Id.* § 50(2).

or on that of the receiver or a creditor.¹⁵¹ The restrictions may be general or directed at specific assets.¹⁵² These provisions seem to aim at the prevention of fraud on creditors. They evidence, however, a policy in favor of close supervision of estate assets, even in the composition context.

The German bankruptcy statutes lack many of the specific provisions that guide a lawyer in structuring escrow arrangements under American or, to a lesser extent, English bankruptcy law. Nonetheless, German law recognizes as matters of general policy the importance of collecting and preserving estate assets and the need for discretion on the part of the receiver in dealing with contractual obligations.

C. *International Recommendations*

This limited review of European law indicates that many of the problems that a lawyer is likely to encounter in an international escrow transaction are conceptually similar to those likely to arise in the United States. For this reason, a prudent first step in structuring an international arrangement is to search the relevant bodies of bankruptcy law for provisions analogous to the provisions of the United States bankruptcy law that deal with executory contracts, property of the estate, and automatic stays. The relevant bodies of law will include the bankruptcy codes of the nations where the parties will locate the escrowed property and where the principals are incorporated or headquartered.

From a drafting perspective, the review of British and West German bankruptcy law suggests that the domestic model proposed earlier in the article often may be a useful starting point. At a minimum, if a draft international agreement appears to ignore the major issues addressed in the domestic model, the American party should not accept it without further inquiry. In particular, counsel for American participants in the transaction should raise the general questions that arise under American law and be fully satisfied that similar problems do not exist in the other nations whose bankruptcy laws may apply.

Finally, as the domestic discussion should make apparent, the likelihood of an arrangement's surviving the licensor's bankruptcy depends on subtleties and nuances of legal analysis. Predicting this

¹⁵¹ *Id.* § 58(1).

¹⁵² These restrictions may consist of a general prohibition against the sale of any assets or a prohibition directed at specific assets. *Id.* § 59. A general prohibition is required to take effect on a specified date, and the terms of the prohibition must be publicly announced and served on the debtor, the creditors, and the trustee. *Id.* § 60. Any transfer made on or after the date of a general prohibition is void against creditors. *Id.* § 62(1)-(2). A transfer in violation of a specific prohibition is similarly void, assuming that the order has been served on the debtor and the trustee, and subject to the protection of bona fide purchasers. *Id.* § 63(1), (3).

outcome depends largely on one's ability to predict responses of bankruptcy courts to particular lines of argument. For this reason, consultation with local counsel before committing a client to a course of action is a worthwhile investment.

IV. Conclusion

Software escrow is clearly not a problem that yields a simple and obvious solution. Therefore, parties should examine with care proposed solutions that claim to be foolproof. Similarly, because the proper balance in any particular situation may depend on factors unique to that situation, parties should approach boilerplate solutions with caution. In either a domestic or international transaction, both parties should be aware of the potential threats to enforcement in bankruptcy and should be sensitive to the need for compromise between the user's desire for certain enforceability and the proprietor's legitimate intellectual property concerns. The models proposed here can serve both as an agenda for the discussion of potential problems and as a framework for compromising the often competing interest of the parties.

