

**Bankruptcy & Insolvency In Outsourcing Arrangements: A Wake-Up Call**

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***“Technology Law 2006: New Frontiers and Challenge:  
global, virtual, open and outsourced”***  
IFLCA 2008 Conference  
Paris  
June 5 & 6, 2008

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## **BANKRUPTCY & INSOLVENCY ISSUES IN OUTSOURCING ARRANGEMENTS: A WAKE-UP CALL**

### **A. INTRODUCTION**

In an ideal world, outsourcing agreements benefit both customers and service providers. However, if either the customer or the service provider becomes bankrupt or insolvent, the outsourcing dynamic will change drastically. In today's unsettled market, outsourcing practitioners need to focus on how best to structure outsourcing arrangements to contemplate the risk of one of the parties suffering from bankruptcy or insolvency. While the specific effects of a bankruptcy or insolvency will vary depending on the nature of the event (e.g. in Canada, whether the party is bankrupt, undergoing a plan of arrangement, or in receivership), in practice such an event will often render moot the carefully crafted language of the outsourcing agreement, even where the agreement expressly contemplates such an event.

While the implication of a customer going insolvent can be equally significant for a service provider, this paper focuses on the implications for a customer of the insolvency of their service provider for the following reason: if at its highest level one characterizes an outsourcing arrangement as the provision of an often complex services offering to a customer in consideration for a fee, the operational/transitional issues raised by the insolvency of a service provider are more complex than the issues regarding the inability of an insolvent customer to pay the service provider – again, at a high level the service provider simply becomes another, often unsecured, creditor with a claim against the estate of the debtor customer.

This paper therefore (a) provides a basic introduction to insolvency law, (b) explains the various risks to an outsourcing arrangement caused by the insolvency of a service provider and proposes methods by which customers can minimise and manage such risks, and (c) proposes that each customer develop a critical response plan so in the early stages of the insolvency or bankruptcy, when timing is critical, the customer is prepared to respond to the risk.

### **B. INSOLVENCY BASICS**

#### ***(1) General Structure of the Canadian Insolvency Regime***

While specifics may vary between jurisdictions, an insolvent person is generally defined as a person with excessive liabilities who is unable to pay their debts. For example, in Canada, the *Bankruptcy and Insolvency Act* (“**BIA**”)<sup>1</sup> defines an insolvent person as a person that owes a creditor at least \$1,000 and whose liabilities to creditors provable as claims under this Act amount to \$1,000 and “(a) who is for any reason unable to meet his obligations as they generally become due, (b) who has ceased paying his current obligations in the ordinary course of business as they generally become due, or (c) the aggregate of whose property is not, at a fair valuation, sufficient, or, if disposed of at a fairly conducted sale under legal process, would not be sufficient to enable payment of all his obligations, due and accruing due”<sup>2</sup>. Similarly, the BIA sets out the conditions that constitute the legal requirements for an insolvent person to become bankrupt. Thus, while all bankrupts are insolvent, not every insolvent person is bankrupt.

The goal of insolvency proceedings is to (a) maximize the value of the estate for the benefit of creditors, and (b) to maintain the *status quo* while the debtor reorganizes or the estate's administrator analyses the

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<sup>1</sup> R.S., 1985, c. B-3.

<sup>2</sup> Section 2, *ibid*.

value of the estate's assets. There are three principal vehicles for managing the affairs of an insolvent person in Canada:

- the BIA,
- the Companies' Creditors Agreement Act ("CCAA")<sup>3</sup>, and
- receiverships.

(a) Bankruptcy and Insolvency Act

The BIA is the principal statute governing for dealing with insolvent persons in Canada. The BIA contains the provisions governing the liquidation of assets through bankruptcy in Canada as well as a process for restructuring in the event of insolvency. "Bankruptcy" is therefore a legal status attained under the BIA.

Restructuring through the BIA involves the use of "**proposals**". Essentially, a BIA proposal involves an agreement between the debtor and its creditors of an acceptable means of restructuring the financial affairs of the debtors, which proceeds with the approval of the court. Generally, BIA proposals are less flexible than proceedings under the CCAA (discussed below).

Formal bankruptcy in Canada results from (a) a debtor voluntarily filing an assignment so as to declare itself bankrupt, (b) a creditor seeking leave from the courts to impose a state of bankruptcy on a debtor, or (c) any failure of a BIA proposal. Under the liquidation provisions of the BIA, a trustee becomes responsible for administering the bankruptcy estate, maximizing its value and distributing its property among creditors in an equitable manner. Subject to certain restrictions, and as described in more detail below, the trustee has the option of either assuming or assigning or disclaiming (rejecting) "executory" contracts<sup>4</sup> and leases that form part of the bankruptcy estate.

(b) Companies' Creditors Agreement Act

Companies facing bankruptcy in Canada may also stay creditors pressing for payments through the CCAA, a federal act that allows corporations the opportunity to restructure their affairs. The CCAA presents an opportunity for a company to avoid bankruptcy and allows its creditors to receive some form of payment for amounts owing to them by allowing the company to restructure its financial affairs, through a formal Plan of Arrangement (a "**plan**"), which is similar to the proposals used under the BIA. The CCAA, is however, restricted to larger companies, as a company must have at least \$5 million owing to creditors in order to be eligible for the Act.

A relatively short piece of legislation, which was originally passed during the Great Depression as a means for large companies to be able to restructure themselves, the CCAA re-emerged in the 1980s as a

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<sup>3</sup> R.S., 1985, c. C-36.

<sup>4</sup> In the United States, for the purposes of Chapter 11 reorganization under the US *Bankruptcy Code*, 11 U.S.C. § 101 *et seq*, the ability to disclaim a contract is premised on the contract being an "executory" contract, which, while it has no statutory definition, is generally defined at common law as a contract where either of the parties remains obliged to perform some act under the contract at present or in the future. However, many US courts employ the "Countryman" definition, wherein a contract is executory if: (a) both parties to a contract owe unperformed obligations to each other, and (b) non-performance by one of the parties represents a material breach that excuses the other party from its obligation to perform (see Vern Countryman, "Executory Contracts in Bankruptcy", (1973) 57 Minn. L. Rev. 439.)

popular option for eligible companies, owing to the flexibility it offers. Because the CCAA contains so few formal rules, proceedings under the CCAA can be tailored by the court to best suit the insolvency at hand. Such flexibility comes at the cost of predictability, however. Further, in practice proceedings under the CCAA tend to be resolved through negotiation rather than litigation.

### (c) Receiverships

An alternative way to liquidate insolvent companies is through the use of a receivership. Receivership involves either (a) having a receiver take possession and control of the debtor's property pursuant to the terms of a security instrument (a "private receivership")<sup>5</sup>, or pursuant to a court order pending payment of an account or resolution of a dispute (a "court appointed receivership")<sup>6</sup>. Receivers are another particularly Canadian method of dealing with an insolvent person, but given that receivership is an option only available to secured creditors, rather than outsourcing customers which are generally unsecured, we will not focus on receiverships in this paper.

### **(2) Current Canadian Insolvency Law**

Again, under the bankruptcy provisions of the BIA, the debtor loses all rights to their property and responsibility for this property becomes the responsibility of the trustee. Additionally, all proceedings by non-secured creditors against the bankrupt are stayed. In this sense, the event of bankruptcy effectively acts as both a sword and a shield for the debtor service provider. As a sword, the event provides the trustee with certain rights to disclaim or assign contracts. As a shield, any "**stay**" (that is, which (a) is triggered by a notice of intention to make a proposal under the BIA, or (b) that applies between the filing of a BIA, proposal and the final disposition, or is generally included as part of a CCAA plan) will suspend certain responses to the insolvency that would otherwise be available to the customer.

### (a) BIA/CCAA as a Sword: Trustee Rights

There are generally two ways by which the trustee of a service provider may transition out of an outsourcing agreement in the event of a bankruptcy – through disclaimer or assignment.

#### (i) Disclaimer

As the law currently stands, there are no statutory provisions in the BIA or the CCAA either expressly permitting or restricting the trustee from disclaiming any contract, other than a restriction on terminating commercial leases. While there is some debate as to the existence of a right to disclaim at common law, in practice a trustee may refuse to perform an outsourcing contract<sup>7</sup>. However, because under both a BIA proposal and a CCAA plan, the debtor remains in possession of contracts, and the debtor has no greater

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<sup>5</sup> In order to have a private receivership, the provision to appoint a receiver will be included in its security documentation. Thus, when the secured creditor realizes its security, a receiver will step in to operate the debtor's business.

<sup>6</sup> Secured creditors can either apply to court for the appointment of a receiver or go to court to seek to have a "interim receiver" appointed. Court appointed receiverships are governed by statute. For example, in Ontario, the *Courts of Justice Act* (R.S.O. 1990., c. C-43) and the Rules of Civil Procedure (R.R.O. 1990, Reg. 194) give the courts the power to appoint a receiver.

<sup>7</sup> Under Canadian law, the landscape concerning partially performed contracts has been somewhat confused by the temptation to import US executory contract concepts into Canadian insolvency law. Yet apart from issues regarding any intellectual property license that may form part of the licence agreement (as discussed below), the issue is largely moot for an outsourcing contract, wherein at least one but possibly both parties will generally have ongoing obligations to perform. For this reason, this paper will not focus on the issues regarding executory or partially performed contracts in any detail.

powers inside BIA or CCAA proceedings than outside, any such a disclaimer will constitute a breach of that contract in accordance with its terms.

Conversely, disclaimer under a CCAA reorganization means dealing with a court driven process. Importantly, while – as noted above – there are no specific statutory provisions either authorizing or restricting disclaimer of any contracts, the courts under the CCAA may permit disclaimer of any “partly performed” contract.

(ii) Assignment

The BIA currently contains no provisions concerning the assignment of contracts, including any provisions which would expressly allow receivers and bankruptcy trustees to assign contracts that either prohibit or require the consent of the counterparty for an assignment (an “**anti-assignment clause**”)<sup>8</sup>.

The CCAA also does not currently deal with the question of assigning contracts, and thus, similarly to the BIA, contains no provisions authorizing assignment of a contract if the contract includes an anti-assignment clause<sup>9</sup>.

(b) BIA/CCAA as a Shield: The Role of Stays under BIA Proposals & CCAA Plans

A customer has certain remedies available to it in the case of a service provider which is insolvent, but not yet bankrupt. The customer can, to the extent that the contract so provides, either (a) invoke performance defaults and other breaches by such service provider to terminate the contract for material breach, in which case any claim for damages will be another (generally) unsecured claim against the estate of the debtor service provider or (b) rely on clauses entitling the counterparty to terminate the agreement based on the fact of the debtor’s insolvency or the commencement of the bankruptcy proceedings (such insolvency-triggered provisions being *ipso facto* clauses<sup>10</sup>).

There are a number of circumstances where the customer may wish to rely on *ipso facto* clauses. For example, as the point of the insolvency the service provider may not have begun to breach its obligations under the outsourcing contract, or if it has, it may be difficult to provide that the defaults amount to material breach. In addition, insolvency termination *ipso facto* clauses sometimes allow for more timely termination than those for material breach, which will often provide the service provider with a significant period in which to cure such breach.

However, it is critical to note that these remedies are largely suspended once a service provider migrates from simple insolvency to bankruptcy or a CCAA process, in that any stay triggered by a BIA proposal or CCAA process suspending the broader contractual, as well as the collection, remedies of creditors.

In the case of a BIA proposal, while the stay is in effect:

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<sup>8</sup> The assignment of commercial leases is governed by provincial law.

<sup>9</sup> While an Ontario court has allowed assignment under the CCAA in one case, *Re Playdium Entertainment Corp.*, 2001 CarswellOnt 4109 (Ont. S.C.J.), the decision was highly factual and thus may have limited value as a precedent.

<sup>10</sup> *Ipsa facto* clauses are contractual provisions that are based on the bankruptcy or insolvency of a party. This is a term adopted from US law.

- *a counterparty to a contract with the debtor company cannot rely on pre-filing defaults in payment:* in the case of a customer, the flow of payment is generally from the customer to the service provider, making this restriction less relevant in any case<sup>11</sup>;
- similarly, *a counterparty to a debtor agreement cannot rely on ipso facto clauses to terminate the contract*, but
- *a counterparty to a debtor agreement can invoke other types of pre-filing breaches by the debtor, if they are sufficiently fundamental, to terminate a contract:* this is more significant for a customer, as it appears to allow a customer to terminate a contract for material breach unrelated to failure to pay (e.g. for failure to perform), even where the defaulting service provider is insolvent.

Relief from the stay can be sought but is very rarely granted by Canadian courts<sup>12</sup>.

While the CCAA does not expressly contemplate a stay, the terms of an initial order under the CCAA are generally whatever the court accepts as appropriate<sup>13</sup>, and virtually every initial order includes a broad stay of proceedings which is broader in its reach and grasp than the statutory stay in BIA proposal proceedings. However, it is important to note that, unlike the BIA stay, the usual CCAA stay order precludes a counterparty to a contract with the debtor from relying on *any* type of pre-filing breach (not just a payment default), as well as from invoking *ipso facto* rights, in order to terminate the contract.

### (3) *Canadian Statutory Reforms*

#### (a) Generally

Canada is currently amending both the BIA and the CCAA.<sup>14</sup> These amendments – while at time of writing not yet in effect – are expected to come into force in 2008 (each, as amended, the “**New BIA**” and the “**New CCAA**”). Once they are implemented, these reforms will have the effect of bringing Canadian

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<sup>11</sup> However, this may have some application in those rarer circumstances where the service provider owes the customer liquidated damages or an equivalent amount due to some form of service provider breach, and has failed to pay same to customer. It is a rarer circumstance because in many outsourcing arrangements amounts will be in the form of credits against future customer payments (e.g. service level credits) in contrast to the service provider being required to provide the customer with actual funds.

<sup>12</sup> The intention of this aspect of the statutory stay is to enable the debtor to compromise its liability for missed pre-filing payments and restore itself to solvency, thereby removing the underlying basis for the *ipso facto* termination rights.

<sup>13</sup> For example, there are currently no specific statutory provisions that authorize the assignment of contracts under either a BIA proposal or a CCAA plan. In both cases, the courts have approved assignment where agreements contains anti-assignment clauses and the counterparty has refused to consent.

<sup>14</sup> Under Bill C-12, *An Act to Amend the Bankruptcy and Insolvency Act, the Companies' Creditors Rights Act, the Wage Earner Protection Program Act and Chapter 47 of the Statutes of Canada*, 2005, which received Royal Assent on December 14, 2007. Bill C-12 has a complicated history. In 2005, Bill C-55 introduced a number of amendments to the BIA and the CCAA. Bill C-55 was passed into law but not proclaimed in force, as the bill was adopted on the eve of the most recent general election and on the understanding that it would not be brought into force until the Senate had the opportunity to conduct hearings on the amendments following the election. In 2007, the government tabled Bill C-62, consisting of additional BIA and CCAA amendments and amendments to the Bill C-55 amendments. That bill died on the order paper when the last session of Parliament was prorogued. Shortly after Parliament reconvened it was resurrected as Bill C-12. As a result, the Bill C-55 amendments have been added to and amended but the combined result is still waiting to be brought into force while regulations necessary for the functioning of the amended BIA and CCAA are prepared.

bankruptcy law closer in line with US law (which is discussed in detail below), albeit with a significant number of differences.

In particular, the reforms will:

- expressly permit the trustee (or equivalent) to disclaim or affirm (assume) agreements;
- for the purposes of the CCAA, expressly eliminate *ipso facto* termination rights;
- expressly provide for the overriding of anti-assignment clauses where such assignment is contemplated as part of the proposal/plan<sup>15</sup>;
- offer protection for lessees, and offer specific protection for intellectual property (“IP”) licensees.

(b) The New BIA/CCAA as a Sword: Trustee Rights

Under the Canadian statutory reforms, while not all elements of the BIA will change, those changes that will be effected are significant.

(i) Disclaimer

In contrast to the current BIA (which has been silent, but under which, in practice, a debtor can either perform its contractual obligations or to choose not to do so and thus breach the agreement), the New BIA<sup>16</sup> expressly permits the disclaimer of certain types of contracts<sup>17</sup> by debtors only if they are carrying on a business and the agreement to be disclaimed relates to the business. Again, however, as was the practice under the previous BIA regime but is now expressly stated in the New BIA, if an agreement is disclaimed, the counterparty customer has a provable claim for losses suffered. Additionally, the proposed disclaimer must be approved by the proposal trustee, and if the proposal trustee does not approve the disclaimer, the debtor may apply to court for an order allowing the disclaimer<sup>18</sup>. If, on the other hand, the proposal trustee approves the disclaimer, the counterparty customer may apply to court for an order disallowing the disclaimer.

Of particular note for customers outsourcing technology services, the New BIA will also include a special rule regarding IP licences: if the debtor service provider has granted a party a right to use IP (such as a software licence), disclaimer of the license will give the customer the option of either treating the license as terminated, or continuing to use the property (including exclusive use if the license is exclusive) for the duration of the term and any term extension to which the counterparty customer is entitled under the

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<sup>15</sup> This effectively serves as a statutory confirmation of an approach already adopted by some courts in connection with a BIA proposal or a CCAA plan; see *supra* note 10.

<sup>16</sup> New BIA, s. 65.11.

<sup>17</sup> This new right to disclaim excludes eligible financial contracts (e.g. a swap or derivative), commercial leases, collective agreements, and financing agreements where debtor is the borrower and real property leases where debtor is a lessor.

<sup>18</sup> In deciding whether to make an order under the proposed s. 65.11 of the New BIA, the court will have to consider, among other things: (a) whether the trustee approved the disclaimer; (b) whether the disclaimer would enhance the prospects of a viable proposal; and (c) whether the disclaimer would likely cause the counterparty significant financial hardship.

agreement, so long as it continues to pay required fees and perform any other obligations it has to the licensor.<sup>19</sup>

While a post-bankruptcy continuation of the licence effectively provides a “breathing space” for the customer licensee so that they have some time to transition away from the software product of the licensor, the absence of a similar carve-out from the right of the trustee to disclaim any maintenance and support agreement for the applicable software means that the customer software will start to become increasingly buggy and out-of-date without the required support. It is not possible to provide effective support without access to the source code. In Canada, the customer can of course mitigate this risk by, prior to the insolvency, arranging for the source code to be deposited into escrow, which source code is then released in the event of a bankruptcy/insolvency event. However, in the US, where similar provisions have existed for some time, the US *Bankruptcy Code* states that if a licensee opts to retain the right of use, it is entitled to have delivered to it any IP called for under the license in such event – e.g. source code. There is no equivalent to this in the BIA and CCAA amendments.

In short, while the Canadian law on possibility of disclaiming IP licensees has been somewhat uncertain<sup>20</sup>, the recent legislative changes will clarify the rights of licensees to continuing using IP licenses in a manner that reflects the long-standing certainty of US law.

All of these changes that apply to the New BIA in relation to disclaimer will also apply to the New CCAA. More specifically, the New CCAA will permit disclaimer with approval of the monitor<sup>21</sup>. However, the disclaimer process under the New CCAA will apply to commercial leases, something that will not be possible under the New BIA.

(ii) Assignment

As described above, the current BIA does not expressly permit a trustee to override such anti-assignment provisions as may be found in a contract. However, the New BIA now expressly provides that a trustee will be able to apply to the courts for an order to approve an assignment of a contract<sup>22</sup>.

This new power will be subject to the following limitations, such that the courts will be able to approve such an assignment where (a) the assignee is able to perform obligations assigned<sup>23</sup>, and where it is “appropriate” to make the assignment; (b) if the trustee making the application is an individual, they must

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<sup>19</sup> New BIA, s. 65.11(7) and New CCAA s. 32(6).

<sup>20</sup> For example, see *Re Erin Features No. 1 Ltd*, [1991] 8 C.B.R. (3d) 205 (B.C.S.C.), where the court and both parties categorized a exclusive distribution licence as an executory contract, but the court refused to comment on the extent to which a trustee had a right to “disclaim” such an “executory” contract and instead characterized the grant of the licence as a transfer of proprietary interests to the licensor which, because it occurred prior to the bankruptcy, effectively removed these interests from assets of the debtor company subject to the management of the trustee. In brief, this decision is generally considered to concluded with the right result – that is, non-interference with an existing licence – but for the wrong reasons.

<sup>21</sup> New CCAA, s. 32.

<sup>22</sup> New BIA, ss. 66(1.1) and 84.1.

<sup>23</sup> One means by which a customer may be able to forestall such an assignment is to include specific obligations in the agreement which only that particular service provider would be able to perform: e.g. requirements for certain specified, named key personnel to be members of the service provider’s project team to assist with transition-in or the performance of the services proper.

be carrying on business; (c) the contract is not an eligible financial contract or a collective agreement; and (d) all monetary defaults have been cured at the time of assignment<sup>24</sup>.

Similarly, while as we have noted that the courts have in some very limited circumstances approved assignment under the CCAA where agreements contains anti-assignment clauses and the counterparty has refused to consent, the New CCAA<sup>25</sup> now expressly permits a debtor to assign its rights and obligations under an agreement by court order. For this assignment to be allowed, a court must be satisfied that (a) the person to whom the rights and obligations are to be assigned is able to perform the obligations (see our note above regarding assignment under the New BIA); (b) it is appropriate to assign the rights and obligations to that person; (c) the proposal trustee/monitor has approved the assignment; and (d) the debtor has cured all monetary defaults as a condition to the assignment.<sup>26</sup>

### (c) The New BIA/CCAA as a Shield: The Role of Stays

Under the current BIA, once a stay has been triggered, the counterparty loses any *ipso facto* rights it might have had. There will be no change to this rule under the New BIA.

However, while under the current CCAA the *ipso facto* right of termination of the counterparty is typically restricted by an initial order, the New CCAA<sup>27</sup> now effectively enshrines in statute this court practice.

### **(3) United States Law**

It is important to appreciate the distinctions between the Canadian and US insolvency regimes given the prevalence of US-based service providers in the market. From a Canadian perspective, the most important distinction is that the US has no procedurally flexible process equivalent to the CCAA – in contrast, the US *Bankruptcy Code* offers a highly formalized set of procedures for dealing with insolvency.

#### (a) US Law as a Sword

Chapter 11 of the US *Bankruptcy Code* provides for the reorganization of a debtor (for our purposes, a service provider), during which time a debtor or trustee can “reject” or “assume” a contract, and, if assumed, can assign it. Rejection under a reorganization represents a breach, whereby the contract is over and the other party can claim damages for the breach. Importantly, rejection is an all or nothing proposition; there can be no cherry picking of parts of the contract or of portions of intertwined groups<sup>28</sup>. Furthermore, rejection requires court approval, for which the appropriate test is the “business judgment” of the debtor as to whether the estate will benefit. Certain special rules also apply to rejection – for example, the right to reject collective agreements or pension plans is severely restricted.

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<sup>24</sup> In the outsourcing context, as the only “payment” that often flows from the service provider to the customer is the provision of services, there could likely be disputes on what is considered “monetary” in this context.

<sup>25</sup> As per the proposed s. 11.3 of the New CCAA.

<sup>26</sup> Note that these sections do not apply to (a) agreements entered into on or after the day proceedings were commenced, (b) eligible financial contracts, or (c) collective agreements.

<sup>27</sup> New CCAA, s. 34(1).

<sup>28</sup> In light of this prohibition on “cherry-picking” parts of a contract, in some cases it may be prudent for the customer to implement an outsourcing agreement structure that includes all aspects of the outsourcing arrangement in one agreement, rather than under a master agreement that includes one master umbrella agreement and multiple ancillary agreements. This limits the ability of the trustee to reject discrete “pieces” of the outsourcing arrangement, to the detriment of the customer which may need all of the pieces for a positive customer result.

Unlike rejection, which results in a breach of contract, assumption under a reorganization preserves and continues the contract. In order for an assumption to be effective, the debtor must (a) cure all defaults, (b) pay the monetary loss caused by defaults, and (c) provide adequate assurance of future performance<sup>29</sup>. As is the case with rejection, assumption also requires court approval, whereby the prevailing test is, again, the “business judgment” of the debtor as to whether the estate will benefit<sup>30</sup>.

Again, Chapter 11 of the US *Bankruptcy Code* overrides anti-assignment clauses so as to permit assignment. If an assumed contract is then assigned, there must be adequate assurance of the future performance of the assignee. However, assignment is not allowed if it is not possible under ordinary law due to the nature of the contract (e.g. a contract for personal services).

Outside of the reorganization context, bankruptcy more generally in the US is governed by Chapter 7 of the US *Bankruptcy Code*. Under a Chapter 7 bankruptcy, effectively for our purposes the same rules apply as are described above relating to a Chapter 11 reorganization. The one significant distinction, however, is that the decision to reject or assume must be made within 60 days, unless a court declares otherwise.

#### (b) US Law as a Shield

As in Canada, during a Chapter 11 US *Bankruptcy Code* reorganization of a debtor service provider), any *ipso facto* termination rights of the customer are stayed. Again, effectively for our purposes the same rules apply under a Chapter 7 bankruptcy as are described above relating to a Chapter 11 reorganization.

#### (4) *Summary*

In summary, the customer faced with a bankrupt service provider needs to mitigate the risks associated with the following two features of the bankruptcy regime: (a) the right of the trustee or their equivalent to disclaim or assign the outsourcing contract, notwithstanding its terms, and (b) the suspension of any *ipso facto* rights – for example, to terminate the contract - that the customer might have had under the terms of such contract.

### **C. IMPACT OF BANKRUPTCY EVENTS ON ELEMENTS OF AN OUTSOURCING TRANSACTION**

Customers and their counsel are aware of the significant adverse effect that the bankruptcy of their outsourcing service provider could have on this business, and will usually contemplate the event in the outsourcing contract. However, (a) the issue is usually only addressed in the termination provisions of the outsourcing agreement, and (b) as we have discussed above, the sword and shield rights provided to the trustee or their equivalent in many cases effectively render moot any related restrictions (e.g. on contract assignment) or *ipso facto* clauses (e.g. bankruptcy-triggered terminations) in the contract which the customer included for their own protection. In response to these concerns, we have made some recommendations below as to some specific risk mitigation mechanisms a customer should consider adopting in contemplation the potential insolvency/bankruptcy of their provider.

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<sup>29</sup> For example, requiring that the debtor service provider provide a parental guarantee.

<sup>30</sup> Whether a contract is rejected or assumed, the decision as to which avenue will be pursued must be made prior to the confirmation of a Chapter 11 plan. However, the court can impose an earlier deadline and there are specified deadlines for real estate leases or sales and personal property leases. In terms of leases, if a debtor as a lessor rejects a lease, the lessee can accept that the lease is gone and claim damages. Alternately, the lessee can continue to use the property and offset damages for other non-performance (such as repair) against rent.

**(1) Avoiding the Stay: Early Warning Mechanisms**

First, the termination provisions in an outsourcing agreement should be re-examined in light of the suspension of a customer's *ipso facto* rights under the outsourcing contract – that is, any rights which are triggered by a bankruptcy event – which occurs during a bankruptcy-related “stay”.

It is common for the occurrence of an insolvency event to act as a termination trigger in the master outsourcing agreement and ancillary agreements. Traditionally, the parties to an outsourcing agreement specifically define the event that could act as the termination trigger. For example, an archetypal termination trigger might be drafted as follows:

If an Insolvency Event has been commenced against a Party and an order approving the Insolvency Proceeding is entered, and such Insolvency Event has remained undischarged for period of sixty (60) days or has not been stayed throughout such 60 day period, where “**Insolvency Event**” means, in respect of any Person: the making of an assignment by such Person for the benefit of its creditors; the failure of such Person to pay its debts generally as they become due; the filing or commencement of a petition or other proceeding in respect of such Person under any bankruptcy, reorganization, moratorium, arrangement of debt or insolvency law of any jurisdiction; the appointment of a receiver, receiver and manager, or interim receiver in respect of such Person or any material part of its assets or business or an application therefor; the becoming or the declaration of bankruptcy or insolvency of such Person; the acknowledgement (in writing or otherwise) by such Person of its insolvency or inability to pay its debts generally as they become due; the making by such Person of any proposal, arrangement or compromise with its creditors under the *Bankruptcy and Insolvency Act* (Canada), or Chapter 11 *United States Bankruptcy Code*, Section 365(n), any other statute, or otherwise; a resolution or a petition filed or an order being made by any court of competent jurisdiction for its winding up; the making of any sale in bulk of such Person's assets; such Person otherwise takes advantage of the laws of insolvency, bankruptcy, or a similar event or proceeding, of any jurisdiction; or the taking of any action for the purposes of any of the foregoing.

The potential problem with insolvency triggers such as these is that to the extent that the criteria for an insolvency event enumerated in the contract are effectively only met in the event of a formal bankruptcy, any rights triggered will be suspended by operation of the stay in any case.

For this reason customers should seek to draft an Insolvency Event definition, or its equivalent, which captures events or circumstances which may be broader than a formal bankruptcy. For example, the following additional event, while not unusual in an insolvency event definition, is helpful in that it is not necessarily a formal bankruptcy event triggering a stay in customer rights:

- if a Party (or, with respect to the Provider, any of the departments or divisions of the Provider involved in providing the Services) suspends its, or ceases to carry on, its business in the ordinary course, except where such cessation occurs in connection with an amalgamation, transfer of assets or other reorganization that is effected in accordance with the provisions hereof, which has no adverse effect on the provision of the Services

Of even more assistance, however, is the inclusion of pre-insolvency “early warning mechanisms”. These mechanisms can be based on formal third party evaluations of the financial status of the service provider: for example, where the provider is of the size that it has a credit rating, the termination trigger might read as follows:

- if Moody's Investors Service, Standard & Poors or Dun & Bradstreet lower the credit rating of the Provider from the rating as of the Effective Date by more than two (2) steps...

However, the customer may require a more flexible mechanism, as for example:

- ... or Customer otherwise has reasonable cause to doubt Provider's financial stability (including concerns over Provider's ability to perform its obligations under any Service Schedule consistently and in a sustained manner).

We should recognize, however, that this does create a difficult dynamic, in that service providers will resist a bankruptcy termination trigger that allows provides the customer with too broad a right to exit, for among other reasons because it allows the customer to avoid paying the early termination fees which will often attend the exercise by a customer of any right to terminate for convenience<sup>31</sup>. If a service provider is going to agree to this broader "bankruptcy" trigger, at a minimum the provider will seek to include an exhaustive list of what might constitute "reasonable cause".

It is important for a number of reasons – including the difficulty of drafting exhaustively all of the potential warning signs of a pending insolvency, in such a way that the service provider can agree to same – to look past the formal *ipso facto* clauses, and focus on implementing early warning governance mechanisms. For example, in addition to reviewing the financial statements of the service provider prior to retaining same, the customer may wish to include a requirement wherein the provider must provide a commit to a certain level of financial reporting on a periodic basis and then must represent and warranty that: (a) all such financial statements, reports, and other information furnished by the service provider to the customer in connection with the initial retention of provider and then on such periodic basis (in any case, no less than annually), fairly and accurately represent the business, properties, financial condition, and results of operations of the provider as of the respective dates, or for the respective periods, covered by such financial statements, reports, or other information, and (b) since the respective dates or periods covered by such financial statements, reports, or other information, there has been no material adverse change in the business, properties, financial condition, or results of operations of the provider<sup>32</sup>.

While the above is useful, in our view it is even more helpful to require the provider to provide, again on such a periodic basis, an officer's certificate certifying that there has been no such material adverse change in the business, properties, financial condition, or results of operations of the provider. Further, it is advantageous for the customer to require that the service provider officer provide such certificate in person, in a meeting with appropriate customer personnel who are able to ask suitable questions regarding the financial status of the company. The in-person meeting requirement forces both parties to focus on the importance of this issue. However, customer should expect the provider to be resistant to disclosing its confidential financial information in connection with any such process.

Finally, it is important to note that *ipso facto* rights are not included by customers in outsourcing agreements solely to trigger a customer rights of termination. For example, an *ipso facto* provision may provide the customer the immediate right to retain certain confidential information:

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<sup>31</sup> For example, customers who used WorldCom as their service provider prior to its bankruptcy had penalties as high as half the costs of remaining with the contract, and only around 20% of customers were able to terminate their agreements cost-free with WorldCom in the event that the financial ability of WorldCom fell below a certain level (see Ann H. Spiotto & James E. Spiotto, "The Ultimate Downside of Outsourcing: Bankruptcy of the Service Provider" (2003) 11 Am. Bankr. Inst. L. Rev. 47 at 62).

<sup>32</sup> Of course, this risk is already somewhat mitigated in the case of public companies, the financial statements for which are public.

[In the case of an event of bankruptcy or insolvency]...Customer shall have the immediate right to retain and take possession for safekeeping all Customer Data, Customer Confidential Information, Customer Intellectual Property Rights and Customer owned materials, software and equipment and Provider shall cooperate fully with Customer and assist Customer in identifying and taking possession of such items; and Customer shall have the right to hold such items above until such time as the trustee or receiver in bankruptcy or other appropriate court officer can provide adequate assurances and evidence that they will be protected from sale, release, inspection, publication or inclusion in any publicly accessible record, document, material or filing. Provider and Customer agree that, without this material provision, the parties would not have entered into this Agreement or provided any right to the possession or use of such items.

If the customer does not build sufficient early warning mechanisms built into the outsourcing agreement and as a result is caught by surprise, the customer will face some challenges. Any stay on terminating the contract for service provider bankruptcy will leave the customer with limited options. The customer could try and terminate for convenience, but in many cases the exercise of such a right will be conditional on the customer paying an early termination fee. On the other hand, the prudent customer will be reluctant to wait for the insolvent provider to start defaulting on its obligations due to a lack of resources. We further examine some of the ways a customer can begin to prepare for such a contingency below.

**(2) *Avoiding the Disclaimer: Provision of and Payment for Transition Services***

Those provisions of outsourcing agreements which require that the provider provide certain post-termination/expiration transitional services form an important component of an outsourcing arrangement. Conceptually, transition services can have two elements: (a) the continuing provision of “ordinary course” services (e.g. in the case of an outsourcing of technology services, the provision of desktop computing services, or help desk services) throughout the transition period; and (b) the provision of “special” transition services – that is, services which are unique to the requirement to transition-out. The focus of these latter services is effectively on the provider providing knowledge transfer and consulting services.

It is not uncommon for a customer to argue that, where it is seeking to terminate the agreement based on the material breach, or the insolvency, of the service provider, the customer should not need to pay for these transition services, particularly these “special” transition services, based on the rationale that such non-payment is one means by which the customer can begin to mitigate its damages (in contrast, the customer would have to pay if the customer terminated the agreement for convenience).

It is important to note, however, that where the customer does successfully argue that it shall not have to pay for the provision of “special” transition services in the case of an insolvency event, the customer may have effectively won the battle but lost the war. More specifically, where the service provider suffers an insolvency event, the trustee or their equivalent will be more likely to disclaim the outsourcing contract and thus the obligation therein to provide such transition services, in the case where there is no compensatory revenue which accompanies such an obligation to perform. As such, in the case of an insolvency event, it may be advantageous for the customer to agree in the outsourcing agreement to pay the service provider for the provision of the transition services. This point would of course equally apply to any aspect of the outsourcing arrangement which might require the provider to provide a service for no fee.

(3) *Limitations of the IP Licence Carve-out from the Right to Disclaim*

Many outsourcing arrangements, including business process and transformational outsourcing arrangements, will include a technology “backbone” such as one or more software licences. We have outlined above how:

- in Canada, under the New BIA and the New CCAA, where the trustee is seeking to disclaim a software or other IP license, the customer will now have the option of either treating the license as terminated, or continuing to use the property (including exclusive use if the license is exclusive) for the duration of the term and any extension the counterparty is entitled to under the agreement, so long as it continues to pay required fees and perform any other obligations it has to the licensor; and
- under §365(n) of the US *Bankruptcy Code* even if a debtor-licensor rejects an intellectual property license<sup>33</sup>, then the licensee may treat the rejection as breach or keep its rights under the license for the remaining term and continue making royalty payments<sup>34</sup>.
- In the case of an outsourcing arrangement, however, the fact that the licence agreement will be preserved post-bankruptcy, while assisting the customer with making transitional arrangements in the short term, will increasingly be less significant if (a) the software is only useful in connection with the outsourcing services provided by the particular service provider, and the applicable outsourcing agreement is disclaimed, or (b) the licensor cannot obtain the source code from escrow, as unsupported software will become increasingly out-of-date and buggy.

In this respect, §365(n) of the US *Bankruptcy Code* regime regarding intellectual property licences is more comprehensive than the Canadian equivalents in the New BIA and the new CCAA, in that s.365(n) requires that, where the licensee elects to retain its rights, on the written request of the licensee the trustee shall to the extent provided in such contract, or any agreement supplementary to such contract, provide to the licensee any intellectual property (including such embodiment) held by the trustee<sup>35</sup>. For a software licensor, this “embodiment of intellectual property” will typically be the object code and source code of the software. Again, as under §365(n), a licensor’s obligation to deliver intellectual property is limited, both before and after rejection, to what the agreement provides, it is critical that the licence - or more likely, an escrow agreement – provide for the release of the software and source code. There is no equivalent requirement under Canadian law, which makes it even more important for a licensee customer to enter into source code escrow agreements for any key software elements of its outsourcing arrangement.

While both the US regime and the developing Canadian regime regarding intellectual property licenses are advantageous for a customer, there are a number of potential pitfalls of which the customer and their counsel should be aware:

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<sup>33</sup> Section 365(n) deals exclusively with licenses for intellectual property that the Bankruptcy Code defines as copyright, patent and trade secrets – note that the section does not extend to trademark licenses.

<sup>34</sup> The catalyst for reform in the US with respect to the treatment of licenses in a bankruptcy or insolvency was *Lubrizol Enterprises v. Richmond Metal Finishers Inc* (See *Lubrizol Enterprises Inc. v. Richmond Metal Fisheries Inc.*, 756 F.2d 104 (1985)). The effect of the Court’s decision was to permit a licensor (in the form of a trustee in bankruptcy) to rescind a license under the guise of rejecting an executory contract. Congress shortly thereafter amended §365(n) of the *Bankruptcy Code* in order to prevent the apparent “chilling effect” this would have on the technology industry.

<sup>35</sup> 11 U.S.C. §365(n)(4).

- In a normal software licence/support arrangement, it would rarely be in the interest of the trustee to disclaim the software licenses/support. Since the trustee has a fiduciary duty to maximize the value of the bankruptcy estate, the trustee will usually maintain software licenses in order to either continue collecting (a) licence fees, where there are ongoing fees, or (b) related maintenance and support fees. In contrast, however, an outsourcing agreement will be structured mainly as a service agreement, such that the license to access and use any underlying application are generally secondary.<sup>36</sup> In those circumstances a court very well may consider the license to be *de minimis* to the overall agreement and – correctly – characterize the outsourcing agreement as something other than an intellectual property license, with the effect that the trustee could reject the outsourcing agreement and the licensee would have no protection. Thus, a licensee entering into an intellectual property licence under the umbrella of an outsourcing agreement should separate the licence agreement from the outsourcing agreement to try to insure protection of the license agreement. In the case of a US service provider, it would also be prudent to include an express reference in the licence agreement that such agreement as an intellectual property license subject to §365(n)<sup>37</sup>.
- A similar “bundling” problem occurs in connection with the requirement that the licensee pay any required fees and perform any other obligations it has to the licensor in order to continue to benefit from the licence. It is therefore important to ensure that the outsourcing agreement clearly separates all fees into their component parts (e.g. into licence fees, hosting fees, help desk fees, etc.). This allows the parties to distinguish between fees for the use of the intellectual property, which the licensee must continue to pay, and fees for services that the licensee no longer receives post-bankruptcy and for which it therefore may be relieved from paying.<sup>38</sup>

Finally, whether the customer receives the software source code as the result of (a) a §365(n) transfer of same from the licensor, or (b) release of same under a source code escrow agreement, in either case the customer will need to be prepared to operate and maintain the software itself, which will raise its own complexities. We examine this issue more closely in below in our review of escrow agreements.

#### **(4) *Limitations of Source Code Escrow Agreements***

In brief, in a source code escrow arrangement, the source code of the proprietary software of the licensor is deposited into an account held by a third party escrow agent to be released to the licensee upon bankruptcy of the company. The purpose of these agreements from the customer’s point of view is to preserve their ability to maintain and support, and therefore use, essential software even if their service provider becomes bankrupt or insolvent, given that it may be cost – or time – prohibitive to obtain and implement replacement software. The traditional “release” trigger for a source code escrow agreement is a bankruptcy event, wherein, as of the point that the bankruptcy event occurs, the third party escrow agent will release the escrow deposit to the beneficiary customer, to be used pursuant to a source code licence. Other common trigger events include insolvency events more generally or the beginning of insolvency procedures. Generally, only a source code licence, rather than ownership of the source code, is provided as the result of the escrow trigger event.

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<sup>36</sup> The same complexities – that is, resulting from the focus being on services rather than the software licence – are raised in ASP (application service provider) and SaaS (software as a service) arrangements.

<sup>37</sup> Unfortunately this recommendation may in some circumstances conflict with the advice earlier provided regarding the strategy of linking together the various component agreements of an outsourcing arrangement into one agreement, to discourage trustees from cherry-picking certain agreements to disclaim.

<sup>38</sup> It is best practice in any case to identify the separate components of the fees, in order to allow for fee adjustments in the case of a partial termination or reduction in service scope.

From a bankruptcy point of view the existence of a source code arrangement with a third party is helpful for the customer in addressing the “sword” and “shield” concerns in a bankruptcy. Regarding the former, a trustee could disclaim a escrow contract – certainty the agreement does not generate any revenue for the trustee, and most will require that the licensor deposit updates with the escrow agent from time, an exercise which requires the licensor to incur a resource cost. However, such disclaimer does not appear to prevent the licensee from exercising their right of release against the escrow agent, the other party to the escrow agreement. Similarly, the existence of a stay means that if the service provider licensor held the source code itself, and upon its bankruptcy the licensee customer sought to enforce the right of the customer to require that the provider release the source code to the customer, this right would be stayed. Under an escrow agreement, however, the right to require release is a right the customer has against the escrow agent.

Currently in Canada a BIA trustee cannot prevent a source code escrowed transfer. However, under the CCAA a court will likely seek to exercise its discretion to prevent the transfer from taking place: for example, where the insolvent service provider wants to continue to permit customers to only have access to object code so that the service provider will continue to benefit from revenue-generating maintenance and support contracts that are ancillary to such object code licence. In other words, the scope of the CCAA stay can be broad enough to prevent the escrow agent from fulfilling its contractual obligation to release the escrow materials. For a customer, this may be very problematic, in particular given that a CCAA plan remains a popular option for eligible companies. The difference derives from the different policy objectives of the two statutes: while the BIA is focused on the liquidation of assets through bankruptcy in Canada as well as a process for restructuring in the event of insolvency, the CCAA has a much greater focus on restructuring in such a way that the debtor can continue to operate as an ongoing concern.

No cases have been published that specifically test the enforceability of a source code escrow agreement in bankruptcy<sup>39</sup>. However, in the United States (which recall has a more formal bankruptcy process which is closer to the Canadian BIA than the CCAA) one court has suggested that source code escrow agreements should be enforceable<sup>40</sup>, and several bankruptcy cases consider the enforceability of other types of escrow agreements<sup>41</sup>. Those cases hold that escrow agreements are enforceable so long as certain formalities, which are best practices in any case, are followed, including that: (a) the escrow agent is a neutral third party which is not affiliated with either the licensor or licensee other than in its capacity as agent for the escrow (and ideally is a party that specializes in administering technology escrow accounts); (b) the source code escrow agreement is a written contract which clearly identifies the property that is to be placed in escrow, establishes the conditions under which the source code is to be released, and - in the event that the source code is released – clearly defines the permissible uses for the released source code; and (c) the source code should be delivered to the escrow agent and be fully documented and commented

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<sup>39</sup> For US discussion, see Risa Lynn Wolf-Smith & Erin L Connor, “Bankruptcy Considerations in Technology Transactions” (April 2004) American Bankruptcy Institute Journal, online: BNet <[http://findarticles.com/p/articles/mi\\_qa5370/is\\_200404/ai\\_n21347709/pg\\_1](http://findarticles.com/p/articles/mi_qa5370/is_200404/ai_n21347709/pg_1)>.

<sup>40</sup> See, e.g., *Behr Venture Partners Ltd. v. Bedford Computer Corp. (In re Bedford Computer Corp.)*, 62 B.R. 555, 568 n.11 (Bankr. D. N.H. 1986) [*Behr*], suggesting that source code escrow agreement maybe effective.

<sup>41</sup> See, e.g., *Hassett v. Blue Cross and Blue Shield of Greater New York (In re O.P.M. Leasing Servs. Inc.)*, 46 B.R. 661, 665 (Bankr. S.D.N.Y. 1985); 5 Collier on Bankruptcy §541.09 (15th ed. rev'd. 1997); cf. e.g., *Rajala v. The Holland Corp. (In re Chesapeake Assoc. Ltd.)*, 141 B.R. 737, 745 (Bankr. D. Kan. 1992), holding that an escrow was ineffective because the escrow agent was an agent of a party and not a neutral third party.

such that the bankruptcy court can identify the escrowed property and distinguish it from other assets of the debtor<sup>42</sup>.

In any case, escrow agreements are by no means a magic bullet, and in fact pose their own challenges. We have outlined below some of the issues regarding escrow agreements of which customers should be aware:

- *Escrow Fees:* while the service provider/licensor will usually seek to shift the responsibility for paying escrow fees to the customer, on the basis that it is effectively an insurance premium, the payment of which benefits only the customer, occasionally a customer with sufficient bargaining power will require that the service provider pay the escrow fees. Each customer should keep in mind that that requiring the service provider to pay the escrow fees raises a risk of non-payment in the case of a service provider insolvency and possibly jeopardizes the escrow agreement, although generally escrow agreements will allow the customer to pay outstanding fees on behalf of the service provider licensor, as required.
  
- *Defining trigger events:* the customer and service provider discussion of the appropriate trigger events will be similar to the discussion regarding the ipso facto termination rights in the licence agreement. The provider/licensor will seek to limit the release trigger event to events of bankruptcy and insolvency, where the customer will seek to include other, broader triggers, such as:
  - licensor ceases to provide maintenance/ support for the software for more than X calendar days (or announces such intention), without any justification under the terms of the agreement
  
  - or, as an aggressive trigger: the source code of the items to be escrowed is made available to any competitor of licensee at no charge, other than as a result of an event of release under any software escrow arrangement to which licensor is a party with any of its customers.

In any case, the trigger events should be clear in order to minimize the risk of disputes regarding same, and the delays attendant with such disputes.

- *Deposit materials:* the customer should to ensure that:
  - the version of the source code to be provided is as up-to-date as is reasonably possible, although increasing the frequency of updates will usually increase the escrow fees;
  
  - the source code is understandable without the help of the service provider, through requiring that the provider licensor include in the deposit materials sufficient documentation, including the contact information of the original developers; their working notes; and some form of “guidebook” to the source code, in particular where the outsourcing includes an initial software “build”/implementation component.

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<sup>42</sup> See *Behr, supra* note 41, holding that a venture capital partner cannot reclaim “new technology” from developer partner who filed bankruptcy, because the court was unable to distinguish “existing technology” from “new technology”.

This is particularly important where the software is to be developed using “agile” programming methodology. Where software is developed using a traditional development methodology, the customer will prepare business/functional requirements (which set out what the customer wants the system to do), in response to which the developer prepares technical specifications (which sets out *how* are the developer is going to technically achieve those requirements). These technical specifications provide a road map/structure to programmers and helps ensure that the service provider fully understands the business requirements. In that more traditional model, the emphasis is including the source code and the technical specifications in the deposit materials.

Agile development methodologies, in contrast, emphasize (a) real-time communication, preferably face-to-face, over written documents, and (b) working software as the primary measure of progress. There is very little written documentation relative to other methods and often no written specifications – agile programming methods are therefore often criticized as undisciplined “hacking”. From an escrow deposit point-of-view, however, it creates some challenges for each customer licensee. For example, without a technical specifications roadmap, it may not be feasible for the customer to “pick up where the service provider left off” with any incomplete development, or even to maintain the software.

- *Two-party vs. three-party agreements:* it is an increasingly common phenomenon for licensors to favour the two-party escrow agreement (i.e. where the licensor and the escrow agent are the parties, and with the licensee listed as a scheduled beneficiary only) rather than the traditional three-party escrow agreement where the licensee is also a party. Licensors rationalize the use of a two-party agreement as being a means to minimize legal transaction costs for each escrow agreement, through discouraging licensees to modify the existing two-party “master” escrow agreement. However, licensee customers should be cautious of risks of not being a party, and therefore not having privity, to the agreement, and the effect on the ability of the licensee to enforce the agreement. As an example, one of the authors had multiple negotiations over time with a well-known escrow agent with respect to their template two-party escrow agreement, in which he pointed out that the two-party escrow agreement template included “no third party beneficiary” boilerplate which had the effect of expressly excluding any non-parties (which would include the scheduled licensee beneficiary) from having any rights under the escrow agreement. The escrow agent agreed to use the three-party escrow agreement.
- *Scope of licence:* it is a common mistake for clients to accept language providing the source code which confirms that it remains subject to the terms of the existing licence, when in fact the existing licence is an object code licence that does not include the necessary permissions to modify, etc. the source code. It is advisable to include a specific source code licence that governs the use of the released source code. This licence can either be effective as of the date that the source code is released, or even more optimally, as of the date of the object code licence, with the practical caveat that the source code licence is unable to be effected unless and until the source code is released from escrow.
- *Clarity of notice provisions:* it is incumbent upon both the customer licensee and service provider licensor to ensure that the notice provisions are clear and make sense, given that the notice provisions are key to how the source code is released. For example, where a licensee claims to the escrow agent that a trigger event has occurred, the licensor is notified by the escrow agent in order to ensure that the licensor has the opportunity to resist the claim if it so wishes. A licensor that misses that notice runs the risk of an inappropriate disclosure of its source code.

In summary, even where an escrow agreement is in place, there remain numerous uncertainties as to how effective it will be as a risk mitigation tool for the customer. As a result, a prudent customer should contemplate potentially two different transition-out scenarios when negotiating outsourcing agreements: a scenario where they will have access to source code in the event of a service provider's bankruptcy or insolvency and a scenario where they do not.

However, even if the agreement works like clockwork such that the source code is released to the customer without a hitch, the "elephant in the room" issue with escrow agreements is that in practice the customer may not be able to make timely and effective use of the source code, for a number of reasons:

- the customer is not in the business of developing/maintaining/supporting software;
- the customer does not have the personnel which are experienced in the development of the software generally, or the specific software in question;
- as a corollary of the above point, the customer will likely need to engage a professional firm to maintain/support, or as required, develop the software, which will take time;
- the more specialized/customized the software, the more improbable it is that even a professional development/maintenance shop will be able to maintain/support/develop the software;
- as noted above, the problem may be exacerbated by inadequate documentation, particularly if agile programming was used; and
- in the case of an outsourcing arrangement, the software was likely hosted by the service provider. Where the software is going to be transferred over to the customer or its designate in connection with post-termination/expiration transition, valuable time may be lost. A customer may want to maintain a "mirrored" site under its control, that is, a site that is identical to the site maintained by the service provider, in order to facilitate a speedy and effective transfer.

In extreme circumstances there are other options available to the customer. For example, a customer could:

- *start off with a source code licence* rather than an object code licence, with all updates being provided in source code form: this can be difficult to negotiate, and expensive;
- propose a *royalty-bearing source code license*, in order to reduce the likelihood of a trustee disclaiming the license;
- include an *option to purchase the software at fair market value*: in addition to the obvious complexities of determining fair market value in this context, this option can be even more difficult to negotiate and expensive than the source code licence option, and further would have to include either (a) a licence-back to the original, selling licensor in order that the licensor could continue to maintain and support other licensee clients, or (b) the licenses of these other licensees in addition to the software, which would then entail customer supporting same (which will be particularly problematic if the other licensees are the competitors of customer);
- take a *security interest in the licensed property or an escrowed assignment*, such that the licensee would seek to enforce its security interest or assignment to obtain ownership; or
- where appropriate and financially feasible, *take an ownership interest in the provider licensor*.

The utility of these proposed remedies will be at least partially dependent on whether the trigger events for these remedies are pre-bankruptcy based, such that there is no stay against any customer remedies. Again, post-stay such *ipso facto* clauses will have no value.

Of the above proposed remedies, only the purchase of an ownership interest in the provider licensor addresses the concern regarding the need of the customer to engage provider personnel who have the requisite expertise to work with and maintain the software. We examine this requirement in more detail below.

#### **(4) Employee, Asset and Real Estate Issues**

##### **(a) Employee Matters: Non-Solicitation & Confidentiality Provisions**

Outsourcing agreements should, in case of a bankruptcy or its equivalent, include the following carve-outs from (a) non-solicitation provisions, and (b) confidentiality provisions. The non-solicitation carve-out should allow the customer to solicit and hire employees of the bankrupt service provider, whereas the confidentiality carve-out allows the customer to use confidential information for the above, and also to facilitate the transition-out to a designee of customer, if required. Again, however, given that these *ipso facto* carve-outs will be suspended by a stay (e.g. in the case of CCAA filing), a customer can best ensure the enforceability of these carve-outs by including triggers which are pre-stay triggers (e.g. non-performance).

##### **(b) Asset Matters: Return of Assets to Customer**

At the time the outsourcing arrangement is being implemented, as part of the requisite “transition-in”, the assets which the customer used to provide the now-to-be-outsourced service may either be (a) rejected by the service provider, (b) sold to the service provider, or (c) leased to the service provider. However, in the case of a bankruptcy the customer may want its assets returned in order to facilitate a smooth transition out. Such a situation is more likely to result if a bankruptcy is early in the term of an outsourcing agreement, as the value for many assets, particularly technology assets, will decrease over time.

In the event that the customer wants its assets returned, the customer should determine which of the following options are available to the customer:

- In the case where the assets were originally sold to the service provider, the customer may include an option, based on the bankruptcy, to buy assets back from the service provider: in this case, although where a stay applies the trustee is not required to sell, the trustee may nevertheless want to sell, as the customer is the most obvious purchaser of the asset in question and the trustee may want the proceeds from sale.
- In the case where assets were originally leased to the service provider, the customer may include an option, based on the bankruptcy, to terminate its asset lease to the service provider: this will only be effective until a stay has occurred such that such *ipso facto* clauses will not be enforceable (e.g. under CCAA filing the service provider may want to continue to provide services in order to obtain the revenue).

##### **(c) Real Estate Matters: Return of Real Estate to Customer**

As part of the transition-in process, real estate - for example office or technology-related space - may be: (a) rejected by the service provider, (b) sold to the service provider, or (c) leased to the service provider.

In the case of an insolvent service provider, a customer may also want to arrange for the return of such real estate.

In the event that the customer wants its real property returned, the customer should determine which of the following options are available to the customer:

- In the case where the real estate was originally sold to the service provider, the customer may include an option, based on the bankruptcy, to buy the real estate back from the service provider. As with the assets example above, although where a stay applies the trustee is not required to sell, the trustee may nevertheless want to sell, as the customer is the most obvious purchaser of the real estate in question and the trustee may want the proceeds from sale.
- The customer includes an option, based on the bankruptcy, to terminate its real estate lease to the service provider: as with assets example above, this will only be effective until a stay has occurred such that such *ipso facto* clauses will not be enforceable (e.g. under CCAA filing the service provider may want to continue to provide services in order to obtain the revenue).

It is therefore advisable to include a fair market value formula, which will generally be definitive unless it is overruled as punitive.

**(5) *Special Issues: Dealing with Likely Service Provider Bankruptcy***

In anticipation of possible service provider bankruptcy, customers should also consider adopting the following options:

- *Parental Guarantees*: this option should be used where the service provider is an undercapitalized entity, but its parent company is well-capitalized. One of the difficulties in using parental guarantees is that it is not always clear the extent to which the parent company is well capitalized. Importantly, parental guarantees continue to operate under a BIA proposal or a CCAA plan<sup>43</sup>, something that will not change with the statutory reforms.
- *Performance Bonds/Letters of Credit*: this option protects customers by allowing for the payment of funds to the customer by a third party (e.g. a bank) upon the occurrence of a service provider default. The challenges in implementing this option include (a) in defining appropriate and objective trigger events, and (b) the often very significant cost to the provider of arranging such a bond. In some cases, the parties may agree to the necessity of a performance bond only during high-risk stages of the outsourcing: for example, during any initial build/implementation stage, or the first year of a roll-out. Moreover, as is the case with parental guarantees, performance bonds/letters of credit continue to operate under a BIA proposal or a CCAA plan<sup>44</sup>, something that will also not change with the statutory reforms.
- *Anticipatory Novation of Agreement*: under this option, the customer selects a replacement provider, in advance, to be put on hold until a bankruptcy occurs, and has them sign a novation agreement. Optimally, such agreement will occur Nance of a pre-stay event, such as non-performance, as any *ipso facto* triggers will of course be ineffective once a stay is implemented. It should also be noted that under this option, a replacement provider will take the opportunity to use the novation agreement as an amending agreement, so as to reflect those revisions the new

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<sup>43</sup> CCAA, s. 11.2.

<sup>44</sup> *Ibid.*

service provider will want in light of the fact that the new service provider is replacing the original. Revisions that could take place include the deletion of carve-outs from a liability cap, the revision of milestone dates, or an increase in fees.

#### **D. DEVELOPING A BANKRUPTCY/INSOLVENCY CRITICAL RESPONSE PLAN**

Once an insolvency has occurred, the primary objective for a customer that has outsourced critical services will be to maintain the provision of these services. It is important that the customer develop and maintain a critical response plan, in advance of receiving notice that the service provider is insolvent or bankrupt, in order to ensure that the customer is able to respond to the insolvency/bankruptcy in a timely way. A prompt response is critical, in that (a) in the event that the customer has received pre-stay warning signs of pending bankruptcy proceedings, the customer will need to use all efforts to “beat the stay” by effecting any remedies it has under the contract, and (b) the customer will want to ramp up its response quickly in order to ensure that it has the possibility of participating in any BIA or CCAA proceedings once initiated.

In order to generate such a plan, customer counsel need to:

- *Know your internal team:* i.e. upon learning of the pending insolvency of the service provider, with which internal personnel will the customer need to liaise in order to make the difficult decisions as to whether to use its *ipso facto* rights to terminate the agreement, trigger the release of source code under escrow, etc. (e.g. the project lead, financial staff, etc.).
- *Know the remedies available under your outsourcing agreement(s):* in order to determine what remedies are available to the customer. For example, the customer may have the ability to reduce scope/in-source, or transfer its service needs to a third party. The customer may also be able to receive assistance from the debtor service provider for transitioning. It is also important that customers assess if they can relocate or purchase assets or IP, or in extreme scenarios, either financially bail out or even purchase the service provider. Similarly, it is important to review what termination rights exist under the contract, that is assess whether termination rights are granted for service level breach, breach of covenant or warranty, force majeure, convenience, change of control or material adverse change, and the applicable cure and notice periods. Additionally, customers need to assess claims for damages, assess cure and notice periods, and, to the extent applicable, pricing formulas and cost adjustment. Finally, the customer will want to ascertain whether any indemnities, guarantees or performance bonds apply, and the implications of any confidentiality restrictions that bind the customer.
- *Know the status of your agreement(s) and the performance of the services thereunder:* it is not possible to assess this in advance, but the customer at the time it learns of the potential provider insolvency issue will need to assess whether the agreement may be coming up on renewal, and the extent to which there may be grounds to terminate for material breach – or less optimally, for convenience – if it is not clear that the insolvency termination threshold has been met. The customer will also want to assess the possibility of negotiating alternative arrangements with the service provider; for example, the customer may agree to end any special projects on which the service provider is working, in order to ensure that the provider continues to provide the core services to the customer.
- *Know the provider personnel:* the customer needs to engage in the due diligence of key personnel, based on liaising with customer operational personnel who have day-to-day contact with the provider personnel, in order to determine which personnel would be potential hires.

- *Know the status of your source code escrow arrangement:* the customer should review the status of the source code escrow deposits. For example, are the source code deposits up-to-date? When was the last deposit made, and is a new deposit pending?
- *Know your pre-insolvency business continuity options:* finally, the customer should evaluate what business continuity measures it can adopt in advance of the occurrence of an insolvency or bankruptcy event for the service provider. For example, upon learning of the possibility of provider insolvency the customer should consider (a) ceasing to transfer confidential information to the provider, and in fact begin transferring such information back; (b) overtly or covertly arranging for knowledge transfer, including arranging for a customer “shadow team” to shadow/liaise with the operational team of the provider, which team can endeavour to learn more details of the provision of the services to facilitate a possible transfer of the services back to the customer or its designate; (c) determining what alternate vendors and their services may be available and tentatively assessing their ability to take over the provision of the services if need be, and (d) assessing the cost of transitioning and negotiating new contracts.

## **E. CONCLUSIONS**

The most critical factor for a customer that will need to respond to an insolvency/bankruptcy event affecting its provider, is timing. Once the bankruptcy event has actually occurred, a number of remedies which may previously have been available to customer may suddenly be off the table due to the effects of the applicable stay, and the trustee will have the ability to assign/disclaim the outsourcing agreement. For this reason, in contemplation of such an event each customer should (a) focus on implementing bankruptcy “early warning” governance and reporting mechanisms, (b) in the case where there software licences underlying the outsourcing arrangement, understand and plan for the fact that escrow arrangements are not a “magic bullet” solution, and (c) plan in advance for the contingency, including the through the implementation of a bankruptcy critical response plan. As with many other outsourcing issues, the customer will best be able to mitigate the risk by investing the time now in planning a response.