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# FOCUS

## President’s Message

**Mark Rogers**

Many thanks to Osborn Maledon for the content of this newsletter. If you’ve been to a chapter program lately or looked at the upcoming events calendar on the chapter’s website, you’ll know that Osborn Maledon is our Platinum Sponsor and, as such, will be providing the CLE for Arizona’s 2010 Ethics Series (taking place at our March, April and May meetings).

The three sessions of the Ethics Series will be as follows: Part I (March) — “2010 Arizona Ethics Update for In-House Counsel”; Part II (April) — “Ethical Implications for Investigations by the SEC and other Governmental Authorities”; and Part III (May) — “Ethics and Privilege Issues in Dealing with Whistleblowers.” I hope to see you at these sessions. As in past years, the programs are on the third Tuesday of each month at The Esplanade’s McCormick & Schmick’s restaurant.

Rounding out the CLE year, we’ll have: “Outside Counsel’s Ethical Duties to Non-Clients: Can Insurance Companies Exert Backdoor Influences Over Your Defense Counsel?” in June; “How the Genetic Information Nondiscrimination Act Applies to Your Wellness Program and Employee Handbook” in July; “The Internet: How to Use It Effectively in Your Cases (Facebook, MySpace, blogs, etc.)” in August; and “Effectively Managing Complex Commercial Litigation” in September. For more information on upcoming chapter programs, go to <http://arizona.acc.com>.

We recently concluded a special three-part professional development series, underwritten by Thomson Reuters and Robert Half. It was a great success. Richard Fincher and Rick Pate received strong reviews from attendees. We hope to continue to offer similar programs on an ongoing basis.

Two key factors will influence how many programs we’ll add to our regular monthly CLE lunch. One is the number of members in the chapter — I’m happy to report that membership is at an all-time high, with nearly 260 members. The second factor is attendance and participation in the programs offered. To make sure the chapter is offering programs you want to attend, we’ll be reviewing attendance data. We’ll also be conducting a survey to fine-tune our offerings. In the meantime, if you have ideas for programs or opinions about where and when to hold programs, please let us know — send an email to [accarizona@yahoo.com](mailto:accarizona@yahoo.com).

As always, thank you for your membership and participation in chapter programs. I hope to see you at an upcoming meeting soon.

## Ethical Issues in the New Service Paradigm

**Susan Hackett, senior vice president and general counsel, Association of Corporate Counsel, Copyright © 2010, Association of Corporate Counsel (ACC)**

Many of you know me lately for my work as an evangelist for the ACC Value Challenge — our project to help corporate counsel and firms reconnect the cost of legal services to their value. But before the ACC Value Challenge dominated my agenda, I spent much of my time working on in-house ethics and professionalism issues.

It's no surprise then that I would eventually seek to marry these two tranches of work. And so I bring the couple before you for your consideration in this column: my goal will be to give you a short overview of some of the professional, ethical issues that will confront corporate counsel who are working with firms to reinvent the legal service provision model by employing new fee structures, new staffing options, new knowledge management techniques, new technologies and more.

We don't have the space or time in this column to go in-depth (see below for links to more material), but many of you will first run into new ethical challenges as you seek to restructure fees for service from hourly rates to other options, and then consider the staffing decisions that such fee structures may dictate. Basically, these arrangements seek to shift the risk of cost/profit from clients (who in the past both paid the firm's "guaranteed" profit, and bore the all the risks of the cost) to firms. Firms in the new paradigm will be asked essentially to "put skin in the game," making them responsible for not only their own efficiency and costs, but also for more of the outcome risk, which may make them less objective about the method of providing their services and the advice they provide. Firms will also face new (but not insurmountable) issues in professional liability and the responsibility to come up with "solutions," in cooperation with other service providers who are not lawyers or who may reside outside the

four walls and insurance coverage of the law firm.

Both the use of hourly fees and the use of value-based fee arrangements<sup>1</sup> can present ethical issues. And the ABA's Model Rules of Professional Conduct in the US, and codes of conduct in other jurisdictions such as Canada, Australia and many European jurisdictions, typically purport to detail the ethical considerations in setting and collecting fees, but are usually unhelpful. Indeed, model rule platitudes — such as, "A lawyer shall not make an agreement for, charge, or collect an unreasonable fee or an unreasonable amount for expenses" (ABA Model Rule 1.5 on Fees), are not only of no help, but often serve to support the proliferation of everything but the most ethical practices. Unreasonable to a client may not be unreasonable to a firm or an ethics authority.

So what are the ethical risks behind the implementation of both hourly or value-based fee arrangements?

Hourly billing can create disincentives to efficiency or encourage waste; it is often cited as supporting "make-work" for firm lawyers who need to bill a certain number of hours per cycle, regardless of whether the work warrants the additional time and effort; it does not encourage firms to assign the right (as opposed to the available/unoccupied/need-to-be-trained) talent to the matter or improve the efficiency of staff members who perform repetitive tasks; it removes accountability from both junior and senior lawyers for the outcome (they see themselves as only

1. I don't like to use the words "alternative fees" since I think that all fees are alternatives that should be considered and chosen based on the matter and the client/firm relationship. The use of the term "value-based fees" infers fees that have been structured to provide the best alternative from the choices available based on what the work is worth and other priorities the client may have, such as speediness, priority, budget pressures, whether the work is repetitive, etc.

responsible for engaging in necessary legal analysis or process), and more, all of which are problems under legal ethics guidelines such as the ABA Model Rules.

Likewise, newly negotiated fee arrangements based on value (and not just hours x rates) are often the result of experimentation between clients and firms with fee and staffing formats they've not tried before; thus, firms and clients may set fees for service that may not be based on an understanding of what the cost will actually be, and this could give rise to wildly inaccurate or unrealistic estimates that firms or clients don't want to be held to. Additionally, new staffing structures can create a lack of responsibility or lack of proper oversight for supervisory relationships (both in poorly coordinated lawyer teams and for outsourced non-lawyers working on matters that the firm used to be entirely responsible for on their own); lawyers without management skill sets will become responsible (a competence issue) for management services or for supervising work done by others that they aren't competent to supervise; a decrease in diligence might be suffered in matters governed by a fixed fee, which removes incentives for lawyers to continue working on a matter that requires investment beyond the normal amount the fee was intended to cover; and lawyers in firms could be deemed to lack objectivity and independence in their guidance if their fees are determined based on outcome.

But let's be clear: the challenges associated with value-based fee and staffing arrangements, albeit different than the challenges associated with hourly fees, are no greater in magnitude. Indeed, I would argue that many of the value-based fee structures that clients and firms are experimenting with offer better incentives to better behavior and remove many of the ethical tensions that have

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plagued lawyers who increasingly feel disenchanted with practice, precisely because they see the misalignment of their firms' business models and billing practices with their client's best interests, and their oath to behave according to the highest principles of professionalism. Bottom line: Ethical lawyers make sure that they behave ethically: there are simply new issues to consider and navigate in the process.

ACC is developing a line of resources to help lawyers in both firms and departments understand these new challenges and assure that their re-designed relationships operate both smoothly and to the highest standards of professionalism. Our initial treatise on the topic is now online on the ACC Value Challenge homepage at [www.acc.com/valuechallenge](http://www.acc.com/valuechallenge). We are also available to travel to chapters and large departments to help them plan ethics workshops that qualify for ethics credits, examine these issues and discuss both best practices and pitfalls to avoid.

Until then, here are a few ideas to consider to ensure that any "value-based" fee and staffing structures you implement are grounded in sound ethical practices:

- Draft agreements that focus the firm on diligent representation regardless of the fee structure — such as fixed fees with "safety valves" or decision trees that plan for variances in how the matter may unfold. Such arrangements should allow for renegotiation or "change orders" when the client objectives change during the course of the representation or allow the firm to assume a new direction when unexpected difficulties arise that could not have been planned for;
- Ensure the fees fairly and adequately compensate the firm's lawyers for the services provided throughout the representation, so as not to provide an incentive to improperly curtail services — the issue is usually not to try to go cheap, but to assure the firm

- that the sustainable profitability that makes the work worth their while yet aligned with client needs;
- Consider up front (and then stick to the agreement) whether firms who put skin in the game and "win" will be able to keep 100 percent or some portion of the windfall; if the firm takes a risk, it should be rewarded so long as the client receives the value it negotiated for.
- Refrain from using a fee arrangement with incentives that could impose a significant material limitation on the lawyers' representation; or if the material limitation is "consent-able," obtain the client's informed consent;
- Base fee prices on data and experience in previous matters, and communicate early and often, enabling clients to make informed decisions regarding representation and to incent the firm to engage in better process and project management and continuous improvement; and
- Explicitly state in the agreement when fees are to be considered earned.

Also, because many law firms' internal cost structures create high-priced fees, some firms can only "stretch" so far; many value-based fee arrangements will make use of legal outsourcing or off-shoring for parts or stages of the work that can be done by non-lawyers. Additionally, many firms are struggling with the appropriate role of their entry-level lawyers or para-professional staff and how they can be trained and contributing. Firms engaging in outsourcing or "pushing the work down" must ensure that the service providers they choose are properly supervised and that they and their work product complies with the requirements of the rules of professional conduct — such supervision can be contracted to the provider (if an outsourcer or contract lawyer company) or made the responsibility of the client's law department or the law firm (when the work is assigned to para-professionals). To successfully make use of legal outsourcing or non-legal staff, lawyers must:

- Ensure the use of properly skilled and well-educated professionals who are trained to the client's needs, and ensure that their work is being monitored and checked upon by licensed lawyers (in the jurisdiction in which the matter takes place);
- Carefully consider when lawyers vs. paralegals vs. business or legal process staffers are the best choice, and make sure that adequate supervision of non-lawyer work is in place;
- Ensure the local legal landscape is adequate to protect the clients' interests or that the contract for services mandates the standards by which you wish their work to be performed (conflicts, professional standards, etc.);
- Assure confidentiality and security through non-disclosure agreements and mandated IT security procedures; and
- Obtain the clients' informed consent regarding any outsourcing plans if there is a risk that clients will believe the firm's lawyers are performing services and not others.

These are but a few of the issues we see arising as the new legal service paradigm shifts the way that clients and firms traditionally related to each other. Do you have suggestions or questions about the ACC Value Challenge and ethics/professionalism issues affecting in-house practice and your client's service? Feel free to contact me at [hackett@acc.com](mailto:hackett@acc.com), and let me know how ACC can help.

# When Patentees Attack!

By Erick Ottoson, Osborn Maledon

Patents are often likened to real property deeds, in that they set forth the metes and bounds of technological “real estate” from which their owners can exclude trespassers. But whereas the world’s supply of real estate is finite, patents are being churned out at a record pace: the USPTO issued about 1.8 million of them in the past decade.<sup>1</sup> Not surprisingly, the nation has seen a corresponding increase in patent lawsuits.<sup>2</sup> Indeed, an entire industry now exists in which entities are formed solely to acquire and assert patents.<sup>3</sup> Given this landscape, the question for technology-focused companies is not whether you’ll be accused of patent infringement, but how soon.

This article discusses some common issues that arise when dealing with a patent licensing demand or litigation threat. To provide context for the discussion that follows, consider the following two scenarios:

- **Scenario 1:** Your company receives a demand letter from an attorney representing Patent Acquisition, Licensing, and Litigation, Inc. (PALL). PALL has a patent that it claims covers your flagship product, and plans to file suit unless you take a license and pay a royalty. Of course, you’ve never heard of PALL’s patent — and neither had PALL until it acquired it from a patent holding company six months ago. Nonetheless, PALL expects compensation for your unlicensed use of its invention.
- **Scenario 2:** Five years ago, your company’s main competitor, Compete Corp., leapfrogged the industry with a revolutionary new widget design. After months of dedicated effort, your company’s engineers unveiled their

own next-generation widget incorporating similar, but not identical, design features. You signed off on the new design after outside counsel performed a thorough patent search, which revealed no infringement concerns. Now, years after the release of your company’s improved widget, Compete Corp. sends a letter informing you of the issuance of its new patent. It plans to assert this patent against your redesigned widget unless you immediately pull it from the market.

As an in-house counsel, threats like these can be daunting. Not only is patent litigation notoriously expensive,<sup>4</sup> but the patentee has a built-in advantage: a government-sanctioned, presumptively valid, monopoly power to wield like a club against your product. What are your options as an accused infringer?

**The basics.** First, arm yourself with some basic patent principles. A patentable invention must be a “new and useful process, machine, manufacture, or composition of matter,” or an improvement thereof (35 U.S.C. § 101). It must not have been previously known to the public (35 U.S.C. § 102), nor obvious to persons of “ordinary” skill in the pertinent field (35 U.S.C. § 103). Once issued, a patent remains in force until twenty years from the date of the application (35 U.S.C. § 154).<sup>5</sup> In many cases, an inventor’s initial application spawns a chain of “continuation” applications. These can be submitted years later, yet still receive the benefit of the initial application’s filing date. (This is what would allow Compete Corp. to assert a brand new patent against a product that had already been on the market for several years.)

As for infringement, it is statutorily defined as making, using, offering to sell, selling, or importing a patented invention (35 U.S.C. § 271(a)). The statute also imposes liability for actively inducing or contributing to another’s infringement (35 U.S.C. § 271(b)-(c)). “Direct” infringement under § 271(a) is a strict liability tort, while § 271(b) and (c) have intent requirements.

**Do we really infringe?** To evaluate infringement, you must consult the patent’s “claims” — numbered sentences at the end of the patent that define the scope of the patentee’s right to exclude. Each claim defines a discrete invention and must be analyzed separately for infringement purposes. This involves two steps: (1) determining what the claim language means; and (2) comparing it to the accused product.<sup>6</sup> The first step, unfortunately, is far less straightforward than one might think. Claims have a language and structure all their own, along with a host of interpretive canons; their precise meaning and scope is often the most hotly-contested issue in an infringement suit. The general idea, though, is that words in a claim are given their ordinary meaning to persons in the pertinent field of technology.

Once you’ve ascertained a claim’s meaning, the next step is comparing it to your accused product. Overall similarity is not the focus — the product must embody *each and every element* of the claim in order to infringe. This concept dovetails with another important principle, which is that patent law permits — and even encourages — competitors to “design around” patented inventions. If you determine that a claim covers your product, consider whether a simple modification might eliminate even one of the required claim elements and render it non-infringing. Note, however, that any design-around attempt must take into account the “doctrine of equivalents.” Even if a claim element is not literally present in the accused product, replacing it with a structure that

1. By contrast, it took nearly a century and a half to issue this many patents following the passage of the original Patent Act in 1790. (Statistics available on [www.uspto.gov](http://www.uspto.gov).)

2. See <http://www.patentlyo.com/patent/2008/03/patent-litigati.html> (visited 1/7/10).

3. These oft-maligned “patent trolls” are generally viewed as opportunistic manipulators of the patent system. *But see* Raymond P. Niro, *Who Is Really Undermining the Patent System – “Patent Trolls” or Congress?*, 6 J. Marshall Rev. Intell. Prop. L. 185 (2007).

4. The average cost of a patent lawsuit with less than \$1 million at stake is \$967,000, according to one survey. This increases to about \$1.8 million when the amount at stake is from \$1-\$25 million. AIPLA, *Report of the Economic Survey* (2009), App. A at I-128.

5. If a patent’s application was filed before June 8, 1995, its term is the longer of seventeen years from the issue date or twenty years from the date of the application to which it claims priority.

6. Some claims are directed to methods or compositions rather than products, but the same two-step analysis applies.

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performs substantially the same function in substantially the same way and yields substantially the same result will not avoid infringement.

**What's our exposure?** The next key question is what damages and other remedies are available to patentees. Section 284 of the Patent Act sets the damages floor at “[no] less than a reasonable royalty,” but a patentee may also attempt to prove lost profits. (In the two opening scenarios, PALL would probably be limited to a reasonable royalty, whereas Compete Corp. could attempt to prove lost profits because it sells a competing product.) Importantly, 35 U.S.C. § 287 precludes damages for *pre-suit* infringement unless the infringer had notice of the patent. This can be actual notice, i.e., a direct accusation of infringement, or constructive notice, which requires marking any patented articles with the patent number. If your company has been selling the accused products for some time, you'll obviously want to investigate the extent to which the patentee has marked.<sup>7</sup>

The Act also provides treble damages for willful infringement. Because of this risk, it has traditionally been standard practice to obtain an opinion of counsel (addressing either non-infringement or patent invalidity, or both) when facing an actual or potential infringement claim. However, under the new willfulness standard (as of 2007), a patentee must prove that the

7. This marking requirement does not apply if a patent's claims are all directed to methods as opposed to products.

infringer acted with reckless disregard of the patent claims. The new standard is generally thought to have lessened the importance of opinions of counsel in patent litigation. But opinions are by no means obsolete and should certainly be part of your calculus, particularly when the amount at stake is significant.

In addition to damages, a patent owner can, of course, seek an injunction. Until recently, a finding of infringement gave rise to a strong presumption in favor of permanent injunctive relief. However, the Supreme Court eliminated this presumption in a 2006 decision, directing courts to apply the traditional four-factor test for injunctive relief.<sup>8</sup>

**Can we go on the offensive?** Finally, consider whether to take the offensive by filing suit for a declaratory judgment of non-infringement and/or patent invalidity. A recent Supreme Court decision<sup>9</sup> broadened the circumstances in which such suits can be filed. An accused infringer can now file suit as long as the patent owner accuses some ongoing or planned activity of infringement, and the purported infringer contends that it has the right to engage in that activity without a license.<sup>10</sup>

Obviously, choosing the time and place for a lawsuit can significantly impact the outcome. This is certainly true in patent

8. *eBay Inc. v. MercExchange, L.L.C.*, 547 U.S. 388 (2006).

9. *MedImmune, Inc. v. Genentech, Inc.*, 549 U.S. 118 (2007).

10. *SanDisk Corp. v. STMicroelectronics, Inc.*, 480 F.3d 1372, 1381 (Fed. Cir. 2007).

litigation, where many plaintiffs favor “rocket docket” such as the patentee-friendly Eastern District of Texas. (Under the applicable venue statute, corporations are deemed to “reside” in any district in which they are subject to personal jurisdiction. Thus, many patent suits against corporations with a national presence proceed in Marshall, TX despite having no particular connection to that district.)

**Conclusion.** Patent law is a specialized area, and it's important to consult with competent counsel upon receiving a licensing demand or litigation threat. Hopefully this brief survey has given you a framework for thinking through the issues, should your company receive a “nasty-gram” of the sort described at the outset of this article.

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## Negotiating Tips for “Software as a Service” Agreements

By Clark Porter, Osborn Maledon

The following guidelines assume the reader has experience negotiating standard perpetual/subsorption term software licenses. The focus below is on Software as a Service (SaaS) agreements, in which your company is asked to pay subscription fees in the neighborhood of \$50,000 per year or more. For subscription agreements significantly below this threshold, or agreements in which the vendor is very large and established, the vendor may be

less willing to negotiate terms and conditions.

Most SaaS subscription agreements are structured to look similar to software licenses. However, there are some additional issues and risks that you should consider when negotiating SaaS contracts. One important risk to consider is the extent to which your sensitive data will be stored on the vendor's (or its subcon-

tractor's) servers, and whether you have contractual guarantees of protection and compliance from the vendor, sufficient for you to comply with your own legal and contractual obligations. The good news is that SaaS vendors realize any significant security breach could destroy their businesses, and, to date, the SaaS industry has not seen very significant security breaches.

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**Implementation and Training.** Clients sometimes assume that because the software will be hosted by the vendor, implementation, training and setup will be a no-brainer. However, we have seen cases where the vendor's sales personnel underestimate the costs of getting a new customer setup and implemented on the SaaS solution. Consider protection from any post-signing surprises, for example through a fixed fee or not-to-exceed T&M agreement for implementation, or (more extreme) a right to terminate without cause and obtain a full refund if the parties later learn that setup and implementation will take significantly more effort and/or time than estimated by the vendor at the time of signing.

**Negotiating Subscription Fees.** Most SaaS vendors will recognize revenue from subscriptions on a ratable basis (monthly over the term of the subscription), so the closing of your deal may not have as big of a revenue impact on the SaaS vendor as would the closing of a year-end deal with a perpetual software license vendor. Typically (but by no means always) the vendor's sales representative receives a commission equal to about one month's worth of subscription fees, but his or her commission may be structured so that he or she benefits from a multi-year commitment, or from deals that close late in the vendor's fiscal year. Bottom line: you still have the most negotiating power with SaaS vendors when you negotiate and close a deal at the end of the vendor's fiscal quarter and are willing to commit to more than a one-year subscription.

**Payment/Renewal Terms.** Issues here are similar to those with software subscription licenses. Many vendors charge annual upfront fees for SaaS subscriptions, but many are flexible and will negotiate for monthly or quarterly payments if pressed. If you are committing to only a one- or two-year SaaS term, negotiate for price protection (and an absolute renewal option) for two years beyond the committed term, if long-term availability of the SaaS is important to your business. Try and limit renewal increases by a percentage (3 percent), and expect the vendor to come back with a CPI concept to protect

against potential high inflation. Unless you have world-class internal controls, push back hard on auto-renewal clauses. The vendor should cave on this issue. Do not give the vendor turn-off or suspension rights in the event of a simple late payment; suspension of service should occur only after a reasonable multiple-notice procedure.

**Security.** In many cases the SaaS vendor may be handling, transmitting and storing sensitive data (in some cases data relating to your customers or clients, or personnel-related data). If you are dealing with a smaller, less-established vendor, you may want to do due diligence and ask the vendor to provide you with its security policies (or if you have a standard questionnaire, you can have the vendor complete it). Also for any smaller, less-established vendor, make sure the vendor has separate location back-up servers, quick disaster recovery capabilities and a written business continuity plan in place. Make sure the vendor warrants in the contract that it will, at a minimum, adhere to its security policy (and good and diligent security policies standard for the industry) throughout the term.

**Your Data.** Where the SaaS vendor will be handling financial or other sensitive data, make sure the vendor has SAS 70 certification and complies with all legal, accounting or other standards that may apply to your own company with respect to the same data. If not already included in the contract, push for provisions that permit you to obtain copies of the SaaS vendor's SAS 70 certification and also, at your option, to perform your own security audit of the vendor from time to time should the need arise. Check with your controller and IT manager as to whether the nature of your data or operations being handled through the SaaS requires that you have the SaaS vendor comply with any other accounting or audit standards. If federal regulations require you to comply with certain standards in the handling of data that the SaaS vendor will be handling, you may need to hold the vendor to the same standards in the contract. Finally, always make sure the vendor is required to completely delete your data at the end of the subscription term and

add a provision for vendor officer certification of deletion upon request (but see Data Dump below).

**SLAs and Technical Support.** Many established SaaS vendors will have Service Level Agreements ("SLAs") with guaranteed uptime (typically in the neighborhood of 99.9 percent, measured on a monthly basis and exclusive of scheduled downtime) with refunds or credits on a sliding scale for any excess downtime. If the subscription agreement does not include an SLA, ask for one. Make sure that any exclusive remedy language in the SLA provisions does not prevent you from having termination for cause rights in the event of repeated failures of the vendor to comply with its SLAs. Obviously, you need to make sure that the vendor's technical support commitments are adequate for your company's anticipated use of the SaaS. The more mission critical the service, the more robust the vendor's support commitment needs to be.

**Offshore Issues.** If important to your business, find out whether any of your data will be stored or handled offshore (or if technical services will be provided by vendor personnel located offshore). If you need assurances that your data will not be stored or handled offshore, put those provisions in the contract.

**Indemnification; Liability Limitation Carve Outs.** While software vendors are often loath to indemnify against anything other than third party infringement claims, many SaaS vendors will, if pushed, agree to indemnify you from any misuse or wrongful disclosure of your data by the vendor or its personnel, or from violations of applicable laws and regulations in the handling of your data. Also, try to get indemnification for any claims arising from any breach by the vendor of its security warranty. Any liability caps in the contract should also have carve-outs for these same issues.

**Insurance.** Given the risk of a security breach or misuse of your data by the SaaS vendor's employees or agents, you should pay more attention to insurance clauses in the SaaS agreement than you might for a

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standard software license. Typically SaaS vendors have more robust insurance policies and many will be willing to add you as a beneficiary.

**Data Dump.** An often overlooked and under-negotiated issue is what happens to your data at the end of the subscription. If you will want to take that data in-house or migrate it to another SaaS vendor, make sure your subscription contract says you can get it from the SaaS vendor in a usable electronic form (at minimal or no cost) at the end of the term, and that the vendor must preserve the data for at least X days following the term to allow you to complete the migration. If the data is

not something the vendor can provide in usable form at the end of term, make sure your business counterparts understand this going into the contract.

**Assignability.** As with most software licenses, negotiate hard for free assignability (without the vendor's consent or the imposition of a transfer fee) in the event of a merger or acquisition event. If the subscription is for an unlimited, enterprise license for the SaaS solution, the vendor has grounds for pushing back and you will need to negotiate reasonable parameters around any M&A related assignment.

*Clark Porter focuses his practice on representing technology and other entrepre-*

*neurial clients, often in connection with the firm's outside general counsel practice. He focuses a majority of his practice on intellectual property and technology-related matters such as licensing, distribution, and procurement, and representing companies in business transactions and corporate governance matters, including mergers and acquisitions, and private equity financing. Clark rejoined Osborn Maledon in 2006 after a five-year stint as Vice President and General Counsel of Cyclone Commerce, Inc. Before joining Cyclone, Clark's practice included representation of most of the larger software companies headquartered in Arizona. He can be reached at 602.640.9374 or cporter@omlaw.com.*

## Four of the Most Common Bankruptcy Issues Confronted by Creditors in Bankruptcy — And What General Counsel Can Do About Them

**By Warren Stapleton, Osborn Maledon**

Given today's difficult economic times, general counsel must be generally conversant with the rights of debtors and creditors. It will be rare for a company to pass through the next two to three years without being impacted by at least one bankruptcy. Below I will attempt to summarize some of the most common bankruptcy issues confronting general counsel, the appropriate solutions, the procedural timeline related to that issue, and provide a range for estimating the budget for dealing with the issue.

### Some Bankruptcy Basics.

#### What type of creditor is my company?

The threshold question confronting every creditor in bankruptcy is: Am I a secured creditor or an unsecured creditor? A secured creditor has a security interest in some collateral held by the debtor. The collateral may consist of the goods shipped by your company, some funds on deposit with the debtor's bank or even real property owned by the debtor. Typically, a security interest is evidenced by a UCC-1 filing with secretary of state, or in the

case of real property, with a deed of trust recorded with the county where the real property is located. If your company is fortunate enough to have security for the money, goods or services it provided, it is governed by the bankruptcy rules related to secured creditors — and has a number of special protections unavailable to other creditors. Most importantly, secured creditors sit atop the bankruptcy priority scheme, i.e., they get paid first. Since an ounce of prevention is worth a pound of cure, if your company suspects one of its customers or clients is financially unsound, it would be a good idea to obtain some security if that result can be achieved.

Far more common is the circumstance where the company does not have security, i.e., the money, goods or services have been provided without requiring any form of security. In these cases, the company is an unsecured creditor. Unsecured creditors are roughly fourth in the bankruptcy priority scheme — behind secured creditors, creditors with administrative claims (people like the debtor's lawyers, or companies doing business with the debtor after the bankruptcy filing), and prior-

ity creditors (like taxing authorities and employee claims for back wages). Typically, unsecured creditors do not recover the full amount of their claim.

#### What kind of bankruptcy is it?

The Bankruptcy Code has several chapters that relate to the type of relief that the debtor is seeking. In Chapter 7, the debtor is liquidating. The liquidation is overseen by a Chapter 7 trustee — a person appointed by the United States Trustee's office that is charged with the fiduciary duty of converting the debtor's remaining assets to cash for distribution to the debtor's creditors in accordance with the priority scheme set up by the Bankruptcy Code. In the typical Chapter 7 situation, there will be little or no distribution to unsecured creditors.

Alternately, a debtor may seek relief under Chapter 11. In Chapter 11, the debtor is reorganizing (or selling) its business. In Chapter 11, the debtor's current management typically runs the debtor for the benefit of the debtor's creditors during the case. In Chapter 11, the debtor will

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propose a plan — typically within 120 days from the date that the debtor filed for bankruptcy — for paying its creditors. The plan, and the accompanying disclosure statement, constitute the debtor’s ‘new contract’ with its creditors and should specify the amount that a creditor can expect to recover. Understanding the debtor’s Chapter 11 plan, and the treatment of your company under the plan is the most important objective in Chapter 11.

### **Problem #1 — Our company has not been paid, and we are unsecured.**

This is the most common problem confronted by general counsel — your company is a creditor in a bankruptcy filed by one of its customers, clients, or vendors. The first thing that your company needs to know is the deadline for filing the proof of claim. In a Chapter 7, notice of this deadline is usually mailed very shortly after the case is filed and generally requires filing the proof of claim 90-100 days after the filing of the bankruptcy. In a Chapter 11, the claims bar date is set by the bankruptcy court and will be specially noticed by the court. Generally speaking, most Chapter 11 debtors’ lawyers like to have proofs of claim on file several weeks in advance of the filing of the Chapter 11 plan. This usually equates to a timeline anywhere between 45 days and 100 days after the filing of the Chapter 11.

Preparing and filing the proof of claim is largely a clerical task. The proof of claim is an official bankruptcy court form (that is uniform across the United States) consisting of one page. Someone in your organization’s accounting unit can fill out the form. It may be mailed or electronically filed with the bankruptcy court. Once on file, provided the debtor does not object to your claim, the filing of a proof of claim entitles your company to be paid its pro rata share of the distribution to unsecured creditors in the case. In a Chapter 7, there may be no such distribution, in a Chapter 11, the timing and amount of the distribution should be set forth in the disclosure statement that accompanies the debtor’s plan of reorganization.

In terms of budgeting, this should not be that expensive. The cost can be partly alleviated by having it handled internally. If it is passed to outside counsel, it should cost anywhere between \$500 and \$1,000.

### **Problem #2 — The debtor is in Chapter 11, it has a contract with my company and wants to do business with my company after the bankruptcy filing**

At first blush, this may not seem like an attractive option. There are, however, a number of Bankruptcy Code provisions that make this a potentially beneficial deal for your company. Ordinarily, the debtor must pay its post-bankruptcy obligations as they come due. If the debtor defaults on those obligations, however, your company may stop delivering goods and services and file an administrative claim under Section 503 of the Bankruptcy Code. Administrative creditors are first in line (after secured creditors) for repayment under the Bankruptcy Code’s priority scheme. (Other types of administrative creditors include the debtor’s lawyer, i.e., you will have the same priority of payment as the debtor’s lawyer.) Payment in full of administrative claims is due on the date the debtor exits Chapter 11— meaning the debtor cannot reorganize without paying your company in full for the post-bankruptcy goods or services that your company provided.

If your company has a valuable contract with the debtor, the debtor may be entitled to assume that contract under Section 365 of the Bankruptcy Code. The debtor has the right to do so, provided that such a contract is executory (i.e., performance is still due on both sides of the contract) and the debtor ‘cures’ any defaults under the contract that arose prior to the bankruptcy. Generally, the cure requires the debtor to pay any amounts that it owed your company under the contract for pre-bankruptcy goods or services. Assumption and cure of an executory contract is one of the few mechanisms by which an unsecured creditor can obtain a 100 percent recovery on its unsecured claim.

In a Chapter 11 the debtor must assume or reject executory contracts before the confirmation of the plan. Plan confirmation has a “floating” deadline usually occurring

6 – 12 months after the filing. The debtor must give notice of the plan confirmation hearing, and of the contracts that it intends to assume or rejection in its disclosure statement and plan (usually filed 120 days after the bankruptcy was filed). The budget for monitoring the case to address an assumption or rejection of an executory contract is flexible, but assuming outside counsel is not actively negotiating the assumption deal, it should range between \$2,500 and \$7,500.

### **Problem #3 — Our company just supplied goods to the debtor and the debtor filed for bankruptcy.**

Even if your company does not have a formal security agreement, if it provided goods within the 45 days prior to the bankruptcy, it may have the right to reclaim such goods — provided that it makes a written demand for reclamation. In 2005, Congress amended the Bankruptcy Code to protect sellers that sold goods to the debtor immediately prior to the debtor’s bankruptcy filing. If your company is in this position, it must serve a written notice of reclamation on the debtor no later than 45 days after the date that the goods were delivered, or no later than 20 days after the bankruptcy was filed (if the 45-day period would expire after the bankruptcy was filed). The wrinkle in this Bankruptcy Code provision is that your reclamation rights are subject to bank liens and warehouseman-type liens that have priority over your claim.

That said, Section 503(b)(9) of the Bankruptcy Code provides an alternative mechanism of protection where, instead of seeking reclamation, your company may seek an administrative claim for any goods delivered in the 20 days prior to the filing. As noted above, administrative claims must be paid before a debtor can exit Chapter 11 and therefore constitute a valuable type of bankruptcy claim.

Generally, a party must file a request for administrative claim by separate motion with the bankruptcy court no later than the administrative claims bar date. The administrative claims bar date is typically set forth in the disclosure statement that

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## Welcome New Members

**Mary-Jeanne Fincher**, Concord Servicing Corporation

**Eric Hitchcock**, INQB8, LLC

**Jan Johnson**, Oxford Life Insurance Company

**Stacey Kelly**, Empre Southwest

**Elizabeth Kinney**, Apollo Group, Inc.

**Roland Lechner**, Microsoft Corporation

**Michelle Marshall**, Scottsdale Unified School District

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**Jeanie Perez**, Starwood Hotels & Resorts Worldwide, Inc.

**German Salazar**, Marix Servicing LLC

**Dwight Whitley**, Sierra Southwest Cooperative Services, Inc.

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accompanies the Chapter 11 debtor's plan. In Chapter 7 cases, it is a good idea to file any administrative claims no later than the 'ordinary' proof of claim bar date. The cost for pursuing a reclamation claim or an administrative claim will vary greatly depending upon the facts of each case. Outside counsel will require a retainer of between \$5,000 and \$10,000 to begin work, which typically can be completed for \$7,500 to \$15,000.

### **Problem # 4 — The debtor owes our company money, but we have been sued by the debtor (or the Chapter 7 trustee)!**

Under the Bankruptcy Code, the Chapter 7 trustee, or the Chapter 11 debtor-in-possession is charged with the fiduciary responsibility of administering all of the debtor's assets. Section 547 of the Bankruptcy Code provides that creditors that received payments on antecedent debt within 90 days before the bankruptcy filing may have received a preferential payment. That is, the creditor receiving such a payment immediately prior to the bankruptcy may actually be getting much more than other unsecured creditors by virtue of its 'last-minute' payment. Lawsuits to recover these 'preference' payments thus constitute an asset of the debtor's bankruptcy estate. The Bankruptcy Code provides that the debtor/trustee may bring these causes of action at any time two years after the filing of the bankruptcy.

There are a number of defenses to preference actions, the two most common being the 'new value' exception and the 'ordinary course' exception. Under the 'new value' exception, the company would not be required to repay any amount of payment for new goods and services provided contemporaneously with the payment. Under the 'ordinary course' exception, the company would not be required to repay any amount paid in the ordinary course of business according to ordinary business terms between the parties. Each of these defenses is fact-intensive and is essentially just like any other type of commercial litigation. Thus, the timeline and the budget for these types of lawsuits stretch in accordance with their complexity and the amounts at stake. A good rule of thumb, however, is that most preference lawsuits can be settled for approximately 50 percent of their value (adjusting up or down depending upon the strength of the individual case). Expect outside counsel's retainer to be in line with any other type of litigation with the preference payment's amount of exposure.

### **Closing remarks.**

This article addresses only a few of the most common types of problems general counsel can expect to encounter in the bankruptcy arena. Although many lawyers view bankruptcy as little more than voodoo, with byzantine procedures that produce wildly unpredictable outcomes, the fact remains that the Bankruptcy Code was written to produce a high degree of certainty in commercial transactions involving distressed companies. Accordingly, competent outside counsel ought to be able to provide general counsel with an appropriate timeline, budget and range of possible outcomes.

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