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SPECIAL REPORT

# Insolvency and Information Technology

Marika Chalkiadis

# INSOLVENCY AND INFORMATION TECHNOLOGY

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# **INSOLVENCY AND INFORMATION TECHNOLOGY**

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# Preface

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The computer industry is presently thriving, but it is a potentially precarious one. Given the pace at which it is growing and the optimism within it, little thought appears to have been given to the "what if?" factor; what if financial difficulties arise, be it as a result of general economic downturn, market saturation, mismanagement or otherwise, and, as a result, insolvency strikes? How will an insolvency affect the IT contracts? What are the parties' respective positions? What is the secured creditor's position and the value of its security?

In writing this Report, I spoke to a number of my colleagues working in the computer industry, and I must say that it was refreshing to see an industry full to the brim with optimism and pragmatism. My background is, however, insolvency and in this field we seem to approach everything from the "what if?" angle (or perhaps that is just me). Therefore, it comes as a surprise to find that others do not share the same, often cynical, perspective of life that we do!

This Report concentrates on corporate insolvency considerations in the computer industry and, within that industry, is particularly concerned with software. It is intended as an introduction only. It does not necessarily provide answers; presently there are no answers to many of the questions posed and it remains to be seen what the courts' attitude will be when (or if) cases start coming before it. That said, where possible, I have tried to give answers (or at the very least, to throw my thoughts into the melting pot) and cover as many issues as possible. However, I see now that I was naïve to think that I could ever do justice to the industry in less than 100 pages!

I have decided to begin the Report with a short chapter on intellectual property rights. I believe that it is useful to introduce terms often encountered but often not really understood by many of us. I then focus on the aims and objectives of this Report, beginning with an attempt to de-mystify the computer industry and the formal corporate insolvency regimes, before considering and analysing how valuable (or otherwise) software might be as security and what happens when formal corporate insolvency regimes meet the computer industry.

Although it probably does not need to be said this Report is intended as a general overview of insolvency and the computer industry, and of (or at least some of) the issues that can arise when they meet. Detailed specialist advice should be obtained however before taking and/or refraining from any action based on, or in relation to, it.

I am grateful to my colleagues at Nabarro Nathanson for their assistance and support in writing this Report, particularly Simon Jones, Paul Golding and Alice Allen in our Information Technology Department, Andrew McLean of our Banking Group, Simon Plant and Edward Craft of our Insolvency Group. Thanks also go to my secretary, Elisabeth Burgess, for all her assistance and for treating me with care when times looked tough.

Marika Chalkiadis  
September 30, 1999

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# 1

## Intellectual Property Rights — An Introduction and Overview

---

What are intellectual property rights? Quite simply, they are the different legal 1.01  
protections afforded to inventors, authors, programmers, designers, etc., in respect of  
their works, giving them rights of a proprietary nature in those works. There are a  
number of rights that can protect the initial “good idea” through to its commercially  
available manifestation, overlapping on occasion. Their common theme is to provide  
protection to the originators of their ideas, enabling them to exploit those ideas for  
commercial gain. Confidentiality of the idea, or its manifestation, is paramount and the  
common thread that binds all of these rights.

There are broadly two categories of intellectual property rights: those arising auto-  
matically (such as copyright), and others that will only arise if applied for and if the  
application is accepted (such as patents). It follows that some intellectual property rights  
are easier to identify or protect than others.

### What are the different types of intellectual property rights?

#### Patents

A patent on an invention confers on the patent holder, in the place where the patent has 1.02  
been obtained, sole rights to use and exploit the invention during the term of the patent.  
In the United Kingdom, the life of a patent is generally 20 years from the date of the  
filing of the application for the patent.

Once an invention (generally a product or process, but see further below) is in  
existence it can be patented, provided the following conditions are met:

- (a) it has been at all times kept confidential to the inventor or any person to whom  
the inventor’s rights have been validly assigned (any necessary disclosure  
having been made strictly in confidence, *e.g.* where the inventor has had to  
disclose details of the invention to a potential funder);
- (b) it is new and involves an inventive step; and
- (c) it is capable of industrial application.

This is one of the intellectual property rights for which an application must be made (and  
registration accepted); they do not arise automatically.

- 1.03 Only the inventor, or any person to whom the inventor has validly assigned his rights, may apply to patent an invention. The situation is, however, complicated slightly where an invention is created by an employee. Generally, the question there is whether or not, in creating the invention, the employee was carrying out his employment duties. If so, then the inventor for patent application rights is the employer and *not* the employee (although the employee may have rights to some compensation from the employer). If, however, the employee created the invention in his own time unconnected with his employment, he will be the inventor.

Not all inventions meeting the above conditions are patentable. The Patents Act 1977 lists exceptions which themselves fall broadly into four categories, namely inventions which:

- (a) are of purely theoretical nature (such as discoveries and mathematical methods);
- (b) are protected by copyright (such as musical works and, of relevance to this report, software);
- (c) may lead to public disorder or criminal or offensive activity; and
- (d) are in respect of varieties of plant or animal.

The position with software may be complicated if the software is contained within an item of equipment, which enables the equipment to do something technically novel. This is just one of the unresolved areas where intellectual property meets the computer industry.

## Copyright

- 1.04 Copyright, like patents, confers sole (albeit in some cases diluted, as in the case of a home video recording of a television programme) rights to the copyright owner to use and exploit the copyright work provided that the work is "original" and has some fixed physical presence. It protects, in favour of the author, the form of the work rather than the idea behind it and, in the United Kingdom, lasts for 70 years after the year of the death of the author. It is one of the intellectual property rights that arises automatically in favour of the author and not by some sort of registration system. It is governed in the United Kingdom by the Copyright Designs and Patents Act 1988 ("CDPA"). Copyright arising in the United Kingdom may be protected in other countries depending upon whether or not that country is a signatory to any relevant convention extending the protection.

In respect of copyright, the relevant works are primarily literary and artistic works. Broadly, a *literary work* is a written work, which can include software, manuals and tables. Literary merit is of no relevance. An *artistic work* can include drawings, photographs and sculptures.

- 1.05 As with patentable inventions, if the work was created by an employee in the course of his employment, his employer will own the copyright (although it is mooted that in some circumstances, the employee may have rights against the employer for compensation). If, however, the employee creates a work in his own time, unconnected with his employment, he will own the copyright in it. This should be distinguished from a situation where a person is commissioned by another to make a work (e.g. where

someone is commissioned to develop bespoke software<sup>1</sup>). In this situation, the copyright owner will be the party commissioned, not the party commissioning.

Copyright may be *assigned* by one copyright owner to another, but section 90 of the CDPA provides, *inter alia*, that for the assignment — which can be partial or complete — to be effective, it must be in writing, signed by, or on behalf of, the assignor. Likewise, copyright may be *licensed* to another, although section 90 of the CDPA provides that a licence may be limited in scope. Section 90(4) provides that “[a] licence granted by a copyright owner is binding on every successor in title to his interest in the copyright, except a purchaser in good faith for valuable consideration and without notice (actual or constructive) of the licence or a person deriving title from such purchaser”.

The rights given by copyright to a copyright owner extend not only to copying and issuing copies of a work, but also to making adaptations of it, showing, performing and broadcasting it and exercising his “moral rights” in respect of it. “Moral rights” are rights that the author may assert in writing:

- (a) to be acknowledged on copies of the work;
- (b) to object to anything being done to the work which might adversely affect his reputation; and
- (c) not to have a work wrongly attributed to him.

## Designs

Some designs (generally, those of a functional nature and/or with some kind of aesthetic appeal intended for commercial production) are capable of protection. Some protection arises automatically, such as design rights protecting shape and configuration, and copyright protecting surface decoration. Other protection arises under a registration system (“registered design”) which is similar to a patent and available generally in respect of novel designs before they go public. This is, however, a complex area into which we will delve no further. In so far as governance in respect of registered designs is concerned, regard should be had to the Registered Designs Act 1949, as amended by the Copyright, Designs and Patents Act 1988.

## Trade marks

A trade mark is an identifying mark, shape, smell, sound, or word that indicates a connection between the person whose trade mark it is and the goods or services in question. Its primary value flows from the goodwill or trade reputation in the marked item or service. Goodwill is extremely hard to define; broadly, however, it is the intangible “something” that attracts and keeps customers and which becomes connected to a business, item or service.

A trade mark might arise in two ways:

- (1) *Automatically by reputation/goodwill*. For example, where a popular product is sold by its name (effectively, by its reputation) rather than its description, the manufacturer of the product will have legal rights to prevent another from

<sup>1</sup> Bespoke software is explained in para. 2.03 below.

competing with him by manufacturing a similar product with a similar name. This is referred to as "passing-off", and occurs where someone seeks to market his goods as those of another, unfairly taking advantage of that other's reputation with resultant prejudice to the other, possibly both financially and as regards reputation (e.g. where the passed-off goods are of an inferior nature). The protection that arises automatically is not absolute; to be successful in a passing-off action, the owner of the product allegedly being passed-off must be able to prove to the court's satisfaction that the offending product name or get-up is indeed so similar that it confuses the consumers.

(2) *By registration at the Trade Marks Registry.* Registration gives the registered holder sole rights to use the trade mark for the goods or services in relation to which it is registered. It is governed by the Trade Marks Act 1994 and the Community Trade Mark Regulation (E.C. 40/94), the latter introducing one system of trade mark registration for the whole of the European Union. To qualify for trade mark registration (which can be perpetual if maintained):

- there must be either existing use of the trade mark or intended use of it;
- the trade mark must be capable of being represented graphically; and
- the trade mark must be capable of distinguishing the items or services as those of the trade mark holder.

A registered trade mark will only be in relation to the goods or services of the class in which the mark has been registered. It will not prevent the same mark being used in respect of another class of goods. There are specified classes for registration purposes and a mark may need to be registered in more than one class to be offered complete protection.

## Know-how

- 1.09 It is worth saying a word or two about "know-how". Know-how is *not* a proprietary right and as such is unlike a patent, copyright or design right. Rather, it is valuable information about how a commercial end may be achieved. For example, the recipe of a commercially popular drink may be know-how. Its primary value lies in its secrecy. The aforementioned recipe would have little value if it were public, thereby enabling anyone to make the drink. Secrecy means that anyone else wishing to make the drink will have to spend money to do so while they try to concoct the same recipe. It is for this reason that, although it is not actually an intellectual property right, it is often treated as such, being assigned or licensed in the same way. It is protected by ensuring that it remains secret, with any necessary disclosure (such as to employees) being clearly made in confidence and for a specified purpose only.



## 2

# The Computer Industry De-mystified — The Constituent Parts of a Computer and Ownership Issues

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Computers have become a part of everyday life, both commercially and in the home. For many, a computer is simply a piece of equipment that allows the user to perform a variety of functions, such as letter writing, game playing and accessing the internet. For the uninitiated, this is an industry beyond comprehension. People talk of “hardware”, “software”, “source codes”, “object codes”, “modems”, but what does it all mean? 2.01

### Hardware

Basically, the equipment that goes to make up the computer is the “hardware”. This includes: 2.02

- the monitor/visual display unit (“VDU”) and keyboard;
- the box in which can be found the central processing unit (“CPU”), the hard disk drive (in which data is stored) and the memory, and which will often have slots for disks and CD-ROMs, from which data can be off-loaded onto the hard disk drive, or onto which data on the hard disk drive can be stored; and
- the modulator and demodulator (the “modem”), which links the computer to a telephone line enabling the computer to receive facsimiles, and voicemail messages, and to connect to the internet.

Therefore, as can be seen, hardware is a tangible asset. It is useless without software, particularly operating system software which is the equivalent of the computer’s brain. No special rules of ownership apply to it. Like any other tangible assets, the ownership trail will more often than not be easy to follow or deduce — from a sales invoice or a lease agreement. On an outright sale, whether or not title has been retained by the manufacturer or the “middle man” distributor (as the case may be) until payment in full of the purchase price will depend on the terms and conditions of sale. Retention of title issues may arise but pose no different questions nor raise any different issues than would arise in respect of any other tangible asset.