Corporate

June 2006

Obscure Case Could Impact Assignment of Software Licenses in M&A Transactions

By David A. Rubenstein and Douglas C. Murray

Almost all companies, whether in technology or more traditional "brick and mortar" industries, are parties to software license agreements under which software providers allow use of their software products. An issue that frequently arises in the merger and acquisition ("M&A") context is whether the company being acquired (the "target") is required to obtain software providers' consents in order to validly transfer its software license agreements to the company buying the target (the "buyer"). The target's ability to transfer its software licenses may be so crucial to the success of a merger that the valid transfer of these licenses is a condition to the buyer's obligation to close the transaction.

A somewhat obscure case from a federal district court in California, *SQL Solutions v. Oracle Corporation*, could unexpectedly impact whether the "inbound" software licenses of a target will be effectively transferred to a buyer. 1991 WL 626458 (N.D. Cal. 1991).

Generally, a party to a software license agreement need not obtain the consent of the licensor to assign the agreement to a third party unless the agreement contains a specific provision to the contrary (an "anti-assignment provision").

Further, in an acquisition by merger, even one in which a software license with a third party (e.g., a vendor, consultant, etc.) contains an anti-assignment provision, a target generally does not need to obtain the third party's permission to assign the software license agreement. This is because under many states' corporate laws, a target's assets (including agreements with third parties) are generally deemed to be "automatically vested" in the surviving entity. That is, there is no "assignment" or "transfer" of the third-party agreement—it simply "becomes" one of the surviving entity's assets. (This is sometimes called an assignment or transfer "by operation of law.")

This is especially true in a "reverse triangular" merger, in which a subsidiary of the buyer is merged into the target, such that the *target is the surviving entity*. Under the law, the target remains the same entity with respect to third-party agreements.

However, in *SQL Solutions*, the federal district court held that a "reverse triangular merger" effected a transfer of a software license, and that this "transfer" resulted in a breach of the anti-assignment provision of the license agreement.

Oracle Corporation ("Oracle") and D&N Systems, Inc. ("D&N") entered into a software license agreement under which Oracle licensed certain software products to D&N. The agreement contained an anti-assignment provision requiring D&N to obtain Oracle's permission to assign or transfer its rights under the agreement to a third party. D&N was subsequently acquired in a reverse triangular merger. D&N was the surviving company, and its name was changed to SQL Solutions, Inc. ("SQL"). Under general corporate law precepts, it would seem that D&N had not assigned or transferred the Oracle agreement, since D&N (later called SQL) was the surviving entity.

Oracle asserted, however, that because D&N had not obtained Oracle's consent to assign or transfer the agreement to the surviving entity (i.e., itself), D&N had breached the anti-assignment provision, and the transfer was not valid. SQL argued that since only a change of stock ownership had occurred in the merger (i.e., the surviving entity was the same as that of the target), no assignment or transfer had occurred, and D&N's rights under the license agreement should have remained automatically vested in SQL.

The court disagreed with SQL, holding that under California law, a "transfer" of rights did occur when the reverse triangular merger was effected. Thus, because SQL did not obtain Oracle's consent to assign or transfer the license agreement to SQL, SQL had breached the anti-assignment provision. The court reasoned that the licensor had the right to consent because the change of control was akin to an assignment in the software area.

Precedential Value of *SQL Solutions*

The precedential value of *SQL Solutions* is unclear. The case has not been reversed or overturned, so it does remain "good law," at least for the Northern District of California—a state in which many software providers are located. Courts in other states have cited *SQL Solutions*; however, the extent to which it will be followed in other jurisdictions remains to be seen.

M&A Considerations

One issue that we have encountered in an M&A context is a buyer's attempt to apply *SQL Solutions* to circumstances that exceed its facts and holding. As discussed, the *SQL Solutions* court held that when a licensee of a software license agreement is the target in a reverse triangular merger, the merger effects a transfer of the license, which requires the licensor's consent to overcome an anti-assignment provision. That is the *SQL Solutions* holding applies to *inbound* software license agreements (e.g., the target is the licensee using the software).

We have encountered situations in which the buyer has attempted to apply *SQL Solutions* to *outbound* software licenses (e.g., the target is the licensor). We have also encountered situations where the buyer has attempted to apply *SQL Solutions* to agreements that were not software license agreements, such as consulting and independent contractor agreements that had a personal service component. Indeed, a court recently rejected a plaintiff's attempt to use *SQL Solutions* to classify the sale of an entity's stock as a "sale" or "transfer" of the entity's real property. *Former Shareholders v. Browning-Ferris Industries*, 2005 WL 2820594 (Cal. App. 6th Dist. 2005).

Conclusion

Given its relative obscurity and unclear precedential value, *SQL Solutions* could unexpectedly impact whether a target's software license agreements will be validly transferred to the buyer in a merger. Thus, a buyer should probably require that appropriate third-party consents be obtained if it is buying a target that holds inbound software license agreements, even in an acquisition by reverse triangular merger. A target company should also be on guard against a buyer's attempt to apply *SQL Solutions* when it is not appropriate to do so.